

REVISITING THE ROLE OF THE FUTURE IN ACCOUNTING REFORM

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Abstract

Overlooked in accounting-reform debate emanating from recent financial reporting scandals is the role of forward-looking disclosure inaugurated in the late 1970s and expanded throughout the 1980s and 1990s. Debate centered on whether accounting concepts developed during this period were too rule-bound. An SEC study largely resolved this debate by characterizing US GAAP as a mix of rules and principles embedded in an objectives-based accounting system. The SEC expressed a slight preference for principles over rules in future accounting standard-setting. Some see this resolution as transformative. This Article considers how it may disguise a false dichotomy likely providing false catharsis. Underappreciated are the terms of a debate intense in the 1960s and 1970s but quiescent amid modernity's preoccupation with the future: the reliability of forward-looking disclosure. This Article revisits that debate and the regime's contributions to financial-fraud risk, showing how contemporary accounting's role has been recast from providing credible numerical history to quixotic narrative prognosis due to pressures from the information age, digitization era and modern finance theory. It is too late and unrealistic to repeal forward-looking disclosure, but short-sighted to overlook its contributions to systemic financial-misstatement risk.

Keywords: accounting theory, accounting reform, forward-looking disclosure, projections, digitization, information, modernity, culture, future, rules-based, principles-based, code-based, objectives-based, natural language, false dichotomies, fairly presents, historical cost, fair value, cash accounting, accrual accounting, narrative financial disclosure, continuous disclosure system, transparency, early warning system, modern finance theory, presentation.

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INTRODUCTION

Contemporary debates in accounting reform ignited by sizable financial frauds overlooked the role of forward-looking disclosure, which this Article revisits. The framework for debating diagnosis and reform was based on false dichotomies arising from a tendency to blame failures on structures rather than attitudes.¹ The frauds were not due to whether accounting concepts are embedded in a rules-based framework rather than a principles-based framework and had little to do with whether there is a difference between complying with accounting concepts and presenting financial information fairly.

Deeper difficulties reside in ravenous appetites for speed and transparency stoked by digitization.² Traditional accounting is incapable of sating these desires. Contemporary pressures from digitization and information-hunger force a system designed to provide primarily numerical histories into one needing to provide narrative prognosis. The frauds likely were more proximately caused by demand for information about the future, which simply does not exist. Forward-looking statements possess intrinsic risk of exaggeration, the core of fraud, and hence disappointment, its manifestation.

Pursuing the balance in this appetite-capacity mix is more promising than haggling about rules versus principles or accounting-compliance versus fair presentation, the false dichotomies that dominated public discourse in frauds' wake. An important aspect of this mix is the balance between accounting as numerical history and accounting as narrative prognosis.³

Part I shows how two inter-related debates engendered by recent accounting frauds met dead-ends. One concerned whether compliance with generally accepted accounting principles (GAAP) facilitates financial statements providing a fair presentation or whether departing from GAAP is necessary. This hinged, in turn, upon

¹ See William L.F. Felstiner, Richard Abel & Austin Sarat, *The Emergence and Transformation of Disputes: Naming, Blaming, Claiming*, 15 L. & SOC'Y REV. 631 (1981) (outlining process of moving from assigning responsibilities not to individuals or groups of people but instead using a systems-based approach to organizational behavior).

² See J. H. Reichman & Paul F. Uhler, *Database Protection at the Crossroads: Recent Developments and Their Impact on Science and Technology*, 14 BERK. TECH. L.J. 793, 812 (1999) ("The near-complete digitization of data collection, manipulation, and dissemination over the past thirty years has ushered in what many regard as the transparency revolution").

³ The theme evokes an old joke about the economist seen searching a parking lot under a street light. Asked what he is doing, the economist says he is looking for his car keys. Prodded as to where he lost them, he replies, "way over there." So why are you looking here, he's asked. Because the light is better here, he says. Substitute economist for accounting-reformer, and the joke applies to recent discussion of accounting reform.

whether GAAP is so rules-based (as opposed to principles-based) as to impair its capacity to deliver financial statements providing a fair presentation.

By reviewing evolution of GAAP from a living natural language into a system supplemented by formal-code, the discussion first suggests that GAAP's qualities do not prevent it from providing a fair presentation and, by reviewing the mixed foundations of GAAP in both rules and principles, confirms that GAAP has this capacity. Accordingly, the discussion shows that these debates are beside the point. The debated issues likely had little or nothing to do with the accounting frauds of the late 1990s and early 2000s.

Pursuing overlooked factors contributing to these episodes, the next two Parts consider accounting's traditional function as numerical history and its increasing call to service as narrative prognosis. Part II provides perspectives on basic accounting theory and concepts, showing accounting's essential character as numerical history epitomized in the balance sheet and income statement. It explains how contemporary debates in accounting practice deemphasize accounting as numerical history to enlist it in more ambitious functions, instancing pressure towards fair-value not historical-cost accounting and cash-flow statement data instead of accrual accounting. It includes a modest proposal for contrast: to improve accounting, abandon the conceit of reporting single precise figures for earnings and owners' equity in favor of reporting faithful ranges for these concepts.

Part III extends this story of accounting's transformation from numerical history to narrative prognosis by explaining the wide variety of circumstances when narrative information is necessary or appropriate as a component of financial reporting. It shows how this vehicle has been used to provide forward-looking information and argues that this process is more likely to create temptations for aggressive or fraudulent accounting than a format of accounting as numerical history. Despite these cautionary views, moreover, this Part shows relentless moves to prognostication in financial reporting, epitomized by newly-sanctioned continuous disclosure concepts and auditor disclosure concerning future financial statement reliability. These comport with a broader cultural preoccupation with the future. For financial reporting, these manifestations risk retarding accounting quality, shown in a penultimate section to be modern finance theory's central contribution to modern accounting.

The Article concludes by emphasizing the daunting character of its implications. Narrative prognosis may be essential to a rational system of financial reporting. But optimizing its balance with numerical history is critical. An imbalance likely contributed more to the late 1990s/early 2000s frauds than accounting's code-qualities or rules-rigidity. Although finding the balance will be elusive, the search will enrich understanding. It can also provide a blueprint for reforming the forward-looking disclosure system along more cautious lines.

I. FALSE DICHOTOMIES IN POWER TALK

According to many, a chief culprit in the accounting scandals of the late 1990s and early 2000s was accounting's rule-based rigidity, sacrificing its principles-based texture.⁴ A tentative solution to this assignment of blame revived a faded idea requiring not only complying with generally accepted accounting principles (GAAP) but presenting a fair presentation of financial results and condition.⁵ The diagnosis and cure both disguise more profoundly important phenomena. Reviewing the discussion's terms shows much ado about the wrong questions, and the ultimate but underappreciated discovery of this misdirection.

A. "Fairly Presents" versus GAAP or Both?

The standard form of audit report in the United States expresses an opinion as to whether an examined set of financial statements *fairly presents* a company's financial position, results of operation, and cash flows, *in conformity with GAAP*.⁶ Two issues and their relation arise. The issues are what is "GAAP" and what does "fairly presents" mean. The relational questions are: is it possible to meet one by meeting the other (say complying with GAAP constituting a fair presentation) and/or does meeting one imply not meeting the other (for example, does a fair presentation necessarily entail overriding GAAP?).

⁴ E.g., Sarbanes-Oxley Act of 2002, § 108(d) Pub. L. No. 107-204, 116 Stat. at ____ ; 15 U.S.C. ____ (directing SEC to study GAAP's rules-versus-principles basis); HARVEY PITT, SEC CHAIRMAN, TESTIMONY BEFORE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS (FASB guidance has "developed based on rules, and not on broad principles," and calling instead for principles to "evolve to become general and principle-based, instead of encyclopedic and rule-based, principles"); FIN. ACCT. STANDARDS BD.: PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING, NO. 107205 (Oct. 2002) (proposal to adopt a principles-based accounting system); SENATE REPORT NO. 107-205, at 13 (2002) (expressing concern about rule-approach to accounting matters); *see also* Stephen C. Gara & Craig J. Langstraat, *The Sarbanes-Oxley Act of 2002: A New Ballgame for Accountants*, 34 U. MEM. L. REV. 73, 93-94 (2003); Anthony J. [sic], *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35, 161-62 (2003); Matthew A. Melone, *United States Accounting Standards: Rules or Principles? The Devil Is Not in the Details*, 58 U. MIAMI L. REV. 1161 (2004) (accepting premise as true, though arguing that the cure does not reside in shifting from a rules-based to a standards-based system).

⁵ Financial "condition" is the label favored by the Securities and Exchange Commission (SEC) to designate the relationship among assets, liabilities and owners' equity as depicted on a balance sheet. *Compare infra* notes 20 & 21.

⁶ Financial "position" is the label favored by the Financial Accounting Principles Board (FASB) to designate the relationship among assets, liabilities and owners' equity as depicted on a balance sheet. *Compare infra* notes 20 & 21.

1. *What is GAAP?* — GAAP can be described as natural language, as code, or both. The latter possibility reveals a preliminary false dichotomy: it is in fact both, though this is often overlooked.

— *GAAP as Natural Living Language*. Generally accepted accounting principles traditionally were those concepts of financial reporting in common use. The concepts constituted a natural living language.⁷ The resulting system was akin to the common law, one that evolves with custom and usage rather than fixed by code.⁸ As with the common law, generally accepted accounting used natural language to apply general concepts to particular facts.⁹ As a natural living language, accounting is grammar recognized as official through general acceptance, a bottom-up approach, not ordained by an official body backed by legal force, a top-down approach.¹⁰

Accounting's traditional character as natural language produced multiple designations for like concepts and variable meanings for similar expressions. Examples endure and appear in how its nomenclature is replete with synonyms. Take the following clusters of terms that for a business entity usually have identical meanings: (1) book value, owners' equity and net worth; (2) earnings, profit and net income; and (3) accounts payable, payables, current obligations, and current liabilities.¹¹ The term "results of operations" is akin to net income, earnings or profits. Even fixed assets go by various terms, including long-term assets; long-lived assets; or property, plant and equipment; the latter often shortened to plant.

The virtue of this natural-language quality is capacity for nuance and tailoring to particular situations from abstract fluid categories. Net income and earnings may usefully

⁷ See Shyam Sunder, *Rethinking the Structure of Accounting and Auditing*, 7 INDIAN ACCOUNTING REVIEW (2003), reprinted in THE ICAI JOURNAL OF AUDIT PRACTICE, www.icfairpress.org (2004) (also available from SSRN.COM, June 16, 2003) [hereinafter Sunder, *Rethinking the Structure*]. In this context, natural living language denotes a system of semiotic communication in which uses define meanings through an endless evolutionary process, contrasted with a view of an idiom of fixed or inherent meaning. See LUDWIG WITTGENSTEIN, INVESTIGATIONS (G.E.M. Anscombe tras. 2d ed. 1967).

⁸ See Gerald J. Postema, *Classical Common Law Jurisprudence (Part I)*, 2 OX. U. COMM. L. J. 155 (2003); Gerald J. Postema, *Classical Common Law Jurisprudence (Part II)*, 3 OX. U. COMM. L. J. 1 (2003).

⁹ See A.W.B. Simpson, *The Common Law and Legal Theory*, in OXFORD ESSAYS IN JURISPRUDENCE, SECOND SERIES 77 (A.W.B. Simpson ed., 1973).

¹⁰ Sunder, *Rethinking the Structure*, *supra* note 7, at 5.

¹¹ See ROBERT N. ANTHONY, RETHINKING THE RULES OF FINANCIAL ACCOUNTING (2004) [hereinafter, ANTHONY, RETHINKING THE RULES].

be distinguished for a specific business, fitting usually-synonymous concepts to a particular context. The adage that accounting is the language of business is rooted in these natural-language origins, where language mediates and maps context. Accounting emerged as financial grammar whose linguistics influenced the behavior and decision-making of information consumers. These qualities can facilitate communication, providing a vocabulary that, through usage, improves a manager's ability to explain and a user's ability to interpret information.

Natural language presents limits. Synonyms, for example, have different significations to different users, producing exchanges in which two people can hold different meanings. A manager may attempt to distinguish net income from earnings but a shareholder may not appreciate the distinction. The result can be misunderstandings, and sub-optimal capital allocation. Synonyms bearing slightly different meanings can slow decision-making, and create inefficiencies in markets where accounting plays a role. Consumers of accounting information can be predisposed to understand terms in certain ways. Sharpening and unifying definitions using unique terms can enhance the mediation to promote optimal interpretation and decisions.¹² This possibility creates appeal for accounting codification.

— *GAAP as Code*. Appeals for codification of generally accepted accounting concepts arose in the 1930s. Perceived failures in the grammar of accounting were blamed, in part, for 1929's stock market crash, along with the financial bubble of the preceding years and the Great Depression that ensued. That decade's reforms (led by the Securities Act of 1933 and the Securities Exchange Act of 1934) deliberately attempted to thwart accounting's character as a living natural language.¹³

A top-down approach was sought, using formal bodies of accounting authorities. From 1939 to 1959, the Committee on Accounting Procedure promulgated accounting's gospel, followed from 1959 to 1973 by the Accounting Principles Board. These accounting leaders articulated accounting concepts using bulletins and opinions, promulgations bearing interpretive qualities of leadership not mandates. As a result, these early pronouncements never fully penetrated the natural language of accounting and never gained the widespread acceptance that the Securities and Exchange Commission (SEC) had hoped since the 1930s that formal accounting pronouncements would achieve.¹⁴

To close on this quest, in 1973 the SEC created the Financial Accounting Standards Board (FASB) to articulate formal accounting doctrine that would be deemed

¹² See AHMED RIAHI-BELKAOU, ACCOUNTING THEORY (4th ed. 2000) [hereinafter, RIAHI-BELKAOU, ACCOUNTING THEORY], at 304-305.

¹³ See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET (rev. ed. 1995) [hereinafter SELIGMAN, TRANSFORMATION OF WALL STREET], at 48-49.

¹⁴ See SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note 13, at 551-53.

generally accepted by fiat. To facilitate this, FASB was anointed with powers broader than its predecessors. It was structured to involve the accounting profession directly in its activities, useful as a way to integrate the concept of general acceptance of accounting as a natural language into the formal promulgation process.¹⁵ The result was more effective than those of FASB's predecessors, a successful top-down approach to accounting. In fact, FASB so succeeded in rendering generally accepted accounting a code-based system that many believed it solved one problem and created another: accounting gospel according to FASB became "an excuse for CPAs to abandon their judgment."¹⁶

Accounting concepts sanctioned as generally accepted by an authoritative body provide codification. FASB's code-setting has more affinities with legislative or statutory directives than with common law evolution. GAAP is founded upon FASB's seven Statements of Financial Accounting Concepts, supplemented by nearly 150 Statements of Financial Accounting Standards, as well as thousands of other detailed interpretations and technical bulletins. As more akin to legislation, FASB's accounting is formal language often prescribing accounting rules with excruciating particularity, especially in its interpretations and bulletins.

This specificity appears in such simple contexts as defining basic concepts known to generally accepted accounting's natural language for at least five centuries. FASB provides precise definitions for the terms assets, liabilities, owners' equity, revenue and expenses.¹⁷ Scores of other concepts are likewise treated as technical tools. Complexities arise in this attempt to tame a natural language, raising questions such as whether gains and losses on the sale of property, plant and equipment are part of income or not, and how a wide variety of other transactions should be accounted for, as by running them through the income statement or recording them directly on the balance sheet as changes in owners' equity.¹⁸ FASB proffers definitive answers to such questions, but the questions are intractable.

¹⁵ Sunder, *Rethinking the Structure*, *supra* note 7, at 7.

¹⁶ *Id.*

¹⁷ FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS (SFAC) 1; *see* LAWRENCE A. CUNNINGHAM, INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS (4th ed. 2004) [hereinafter, CUNNINGHAM, INTRODUCTORY ACCOUNTING], at 500 *ff.* (glossary entries defining these concepts both in general terms and formal FASB terms)

¹⁸ CUNNINGHAM, INTRODUCTORY ACCOUNTING, *supra* note 17, ch. 7; *see, e.g.*, FIN. ACCT. STNDS. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 130, REPORTING COMPREHENSIVE INCOME.

— *A Preliminary False Dichotomy*. The intractability of many accounting questions renders FASB's codification of generally accepted accounting concepts necessarily partial. It can be neither comprehensive in scope nor exhaustive in its treatments. In fact, despite FASB's leadership, GAAP remains rooted in numerous sources, not articulated in a single code. The United States Supreme Court has noted that as many as 19 different sources constituting GAAP could control an accounting issue, variously providing conflicting solutions to identical situations.¹⁹

The choice between natural language and code reveals a preliminary false dichotomy. Continuing the legal parallel, it is as if legislatures alone could pronounce law with finitude, dispensing with the need to interpret and apply statutes in particular contexts, as done in a common-law system, first by practicing lawyers and sometimes ultimately by judges. Even the most ambitious codification movements in law never achieved such absolutism.²⁰

Even with FASB's partial codification, for example, basic terms can bear open-ended meanings. Consider various terms used to designate the balance sheet, which include the statement of position and the statement of condition.²¹ FASB prefers the term statement of position while the Securities and Exchange Commission (SEC) prefers the

¹⁹ *Shalala v. Guernsey Memorial Hospital*, 514 U.S. 87, 101 (1995) (Kennedy, J.) (lamenting that "there are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question"). These include FASB Statements, Interpretations, Technical Bulletins, Implementation Guides; Accounting Research Bulletins; Accounting Principles Board Opinions; AICPA Statements of Position, Accounting Guides, Practice Bulletins, Accounting Interpretations and Issue Papers; SEC Rules and Regulations; and Emerging Issues Task Force Abstracts, Minutes and Issue Summaries.

²⁰ *E.g.*, Larry Alexander & Emily Sherwin, *The Deceptive Nature of Rules*, 142 U. PA. L. REV. 1191 (1994). Codification is the systematic integration and expression of a body of knowledge in a single compendium. In law, this process is often presented as an alternative to common law; in practice, this vision is functionally unachievable. The tradition dates to the Code Napoleon, includes codes developed by Jeremy Bentham and David Dudley Field, restatements promulgated by the American Law Institute, various Congressional bodies of law such as bankruptcy and tax and—in all states but Louisiana, itself a product of the Code Napoleon—the UCC. The UCC is probably the most successful codification effort, but even its crisp terms depend on judicial interpretation through application of principles. *See infra* text accompanying notes 47 to 48 (discussing legal positivism versus modern legal theory).

²¹ Notice the use of these apparently interchangeable terms in the first two paragraphs of this Part I, *supra* notes 5 & 6 and accompanying text.

term statement of condition.²² The marketplace still calls it a balance sheet. However denominated, this document is a record of the cost of measurable resources not used up, arrayed against obligations of liability-claimants and owners. It is not intended to reveal financial status, whether denominated as condition, position or other such term.

Calling the balance sheet a statement of condition is almost certainly misleading, and even statement of position may fail adequately to express its limits. (Statement of circumstance is closer to reality.) Balance sheet—the term that emerged from accounting’s origins in natural language to reflect claims commanded balanced with claims owed²³—is more faithful to its capacity than FASB’s or the SEC’s terms. However the document is denominated, these limits on the balance sheet and on formal efforts to ordain accounting concepts by fiat relate to the meaning of the concept “fairly presents.”

2. *What is “Fairly Presents”?* — The term fairly presents is not defined by law in the United States nor in authoritative accounting literature.²⁴ This reticence echoes the old-fashioned sense of accounting as natural language. But the concept entered the vocabulary as part of the formal securities regulatory process, as formal code-like legal articulation rather than as natural living language.²⁵ Yet even using this approach, the reticence to define it reflects a sensibility familiar to the common law, of leaving to professional judgment the ultimate application of general concepts to specific situations.

The meaning of “fairly presents” depends on what a system of financial reporting is designed to depict. Meeting the view may mean tracking assets, liabilities, owners’ equity, revenues and expenses using the foundational objectives and purposes of accounting, whether these exercises are animated by general acceptance or articulated, code-like, by FASB or other bodies.

²² Compare FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS (SFAC) 1 ____ with SEC Regulation S-X, § ____.

²³ See GARY JOHN PREVITS & BARBARA DUBIS MERINO, A HISTORY OF ACCOUNTANCY IN THE UNITED STATES: THE CULTURAL SIGNIFICANCE OF ACCOUNTING (1998) (explaining derivation of concepts of debit and credit used in bookkeeping to kindred Italian words, *debitore* and *creditore*, which mean literally debtor and creditor).

²⁴ Compare AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, THE MEANING OF “PRESENT FAIRLY IN CONFORMITY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES” IN THE INDEPENDENT AUDITOR’S REPORT, STATEMENT ON AUDITING STANDARDS NO. 69 (1992).

²⁵ See Lawrence A. Cunningham, *Semiotics, Hermeneutics and Cash: An Essay on the True and Fair View*, 28 N. C. J. INT’L L. & COMM. REG. 893 (2003) (tracing concept’s history).

The result of applying these exercises consistently should reliably mirror external business activity. When this occurs, the result should “present fairly,” representing economic reality. But accounting concepts are tools, not truths. Judgment is necessary to determine that their application in particular settings produces faithful measures of economic reality.

Accounting concepts are generalizations—no matter how detailed their specification—and applying them is particularization. A code can declare that an asset is a resource not used up but deciding whether an investment in a new technology is such a resource, and therefore an asset, requires judgment.

With any statement of accounting concepts, there will be numerous potentially correct reporting methods. A requirement to “present fairly” can therefore be met in a variety of ways. The requirement captures a range of fidelity to economic reality. Complying with applicable accounting concepts, however these are ordained, may not be enough. Economic realities are measured by the instruments of accounting but the common law mind-set rightly doubts its ability to craft *ex ante* directives universally applicable to reflect them faithfully.

This reality produced an apparent dichotomy between complying with GAAP on the one hand and providing a fair presentation on the other. It famously appeared—and then was neglected for nearly two generations—in Judge Henry Friendly’s opinion in *United States v. Simon*.²⁶ In reviewing an accountant’s potential liability for fraudulent financial reporting, Judge Friendly said that compliance with GAAP does not necessarily satisfy the fairly-presents requirement.²⁷

At trial, the accountant sought a jury instruction stating that he could not be guilty of fraud unless *under GAAP*, the financial statements he certified did not fairly present the company’s financial condition and results.²⁸ Rejecting this proposed instruction, Judge Friendly instead defined the issue as whether the financial statements, taken as a whole, fairly present the company’s financial condition and results.²⁹

²⁶ 425 F.2d 796 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970).

²⁷ *Id.* at 805-06. For a current re-assessment of the case, see James D. Cox, *Reforming the Culture of Financial Reporting: The PCAOB and the Metrics for Accounting Measurements*, 81 WASH. U. L. Q. 301, 319-20 (2003).

²⁸ The proposed jury instruction further qualified that liability could only be found if, in addition, any departure from GAAP involved willful disregard and the accountant knew the financials were false and held an intent to deceive. *United States v. Simon*, 425 F.2d 796, ____.

²⁹ If they do not, then the issue is whether the accountant acted in good faith. Proving compliance with GAAP evidences good faith, but is not conclusive. Relevant factors include the authoritative quality of the sources relied on in forming the judgment about what GAAP required.

The case thus distinguishes between compliance with GAAP and achieving a fair presentation, and elevates the latter to primary importance. If complying with GAAP does not produce a fair presentation, then compliance with GAAP is subordinated to promoting a fair presentation. In such cases, GAAP must be overridden.

The apparent duality between compliance with GAAP and fair presentation continued (and continues) to appear in the language contained in standard audit reports. But the case was never generalized in federal securities litigation or enforcement to achieve enduring legal significance.³⁰ In accounting and auditing practice, moreover, it was essentially assumed that compliance with GAAP meant a fair presentation. This assumption could be accurate if GAAP's generality is sufficiently capacious to permit fair tailoring for application to particular contexts.

3. *Falsity in the Dichotomy* —When accounting scandals erupted in the early 2000s, accounting authorities returned to Judge Friendly's desuetude distinction. Perhaps fair presentation does differ from complying with GAAP and should be made primary. If so, then it will sometimes not be possible for an auditor to give the standard form of opinion, that financial statements both comply with GAAP and fairly present a company's financial performance and condition. If so, a quiet revolution occurred.

Consider a post-scandal SEC pronouncement addressing the relationship between compliance with GAAP and fairly presents. The pronouncement accompanied explanation of corporate-officer certification requirements imposed under the Sarbanes-Oxley Act. These require top officers to attest that financial statements do both, comply with GAAP and fairly present. The SEC, reviving Judge Friendly's long-ignored approach, privileged fairly presents over GAAP.

The SEC specified that its regulations require certification that "the overall financial disclosure fairly presents, in all material respects, the company's financial condition, results of operations and cash flows."³¹ The SEC clarified that the certification is not limited to an attestation that the financial statements accord with GAAP, emphasizing instead the broader requirement of "overall material accuracy and completeness."³² Furthermore, it declared: "Presenting financial information in

³⁰ See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B. U. L. REV. 301, ____ (2004) [hereinafter, Coffee, *Gatekeeper Failure and Reform*] (reporting inability to find any cases relying upon this ruling in *United States v. Simon*). Relics of the case appear in two SEC releases concerning its enforcement actions. See *In re Caterpillar, Inc.*, SEC RELEASE NO. 34-30532 (March 31, 1992); *Edison Schools, Inc.*, SEC RELEASE NO. 34-45925 (May 14, 2002).

³¹ See SECURITIES AND EXCHANGE COMMISSION, CERTIFICATION OF DISCLOSURE IN COMPANIES' QUARTERLY AND ANNUAL REPORTS, RELEASE NO. 33-8124 (Aug. 28, 2002).

³² *Id.*

conformity with generally accepted accounting principles may not necessarily satisfy obligations under the antifraud provisions of the federal securities laws.”³³

The SEC by fiat thus declares dead a practice norm that compliance with GAAP is both necessary and sufficient to achieve a fair presentation. As a matter of logic, this SEC position should mean that the standard form of audit letter should be changed: it is possible (even likely) for GAAP-compliance to be inadequate to reach a fair presentation. If so, the latter is to be privileged and the audit report would have to say the statements fairly present, whether or not in compliance with GAAP. Yet this revision to the standard audit report has not been made. Instead, debate moved to a different plane, concerning the congruence of GAAP with the fairly presents requirement. That is, it became a question of GAAP’s capacity to yield a fair presentation.

B. Rules versus Principles or Both?

Revelation in the early 2000s of numerous spectacular accounting frauds spawned a seemingly-vigorous debate in contemporary accounting policy. The debate centered on whether GAAP had become too rule-bound in FASB’s top-down mandates, losing its principles-orientation associated with its natural-language origins that would congeal with the fairly presents requirement. If too rule-bound, compliance with GAAP would impair the possibility of meeting the fairly-presents obligation. Virtually all participants in the debate assumed that GAAP was exceedingly rules-based.³⁴ They could point to three forces creating this perceived condition.

³³ *Id.*, n. 55. Thus the SEC takes the position that a “fair presentation” is not about results alone but also about:

the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer’s financial condition, results of operations and cash flows.

Id.

³⁴ See *supra* note 4. For a refreshing exception in the legal literature, see William W. Bratton, *Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1045-52 (2003) [hereinafter Bratton, *Rules Versus Principles Versus Rents*] (providing a four-part rebuttal to the assertion, and also noting that the auditing profession preferred the existing conception of a rules-based approach though urged changes in the rules); see also Katherine Schipper, *Principles-Based Accounting Principles*, ACCOUNTING HORIZONS (March 2003) (explaining how principles emerge when promulgated according to an underlying conceptual framework).

First, FASB's codification mandate and resulting efforts made it a creator of rules rather than principles. And this was of course exactly what it was told to do. Second, auditors might prefer a rule to a principle when this relieves them of the anxiety (and legal risks) of exercising judgment.³⁵ Letters are easier than spirits to defend, and auditors played a major role in shaping FASB's promulgations.³⁶ Third, some opined that as business transactions grow more sophisticated and complex, accounting concepts follow suit through dense complex rules not broad general principles.³⁷

Most participants in this debate proceeded with little examination of the assumption that FASB produced rules not principles and that resulting GAAP was too heavily rules-based, sacrificing its principles-based, natural-language qualities.³⁸ In part because it is impossible to prove that any accounting system is more rules-based or principles-based, commentators compared US GAAP to other accounting systems.³⁹ Most saw evidence of looser, principles-based accounting systems used in other countries. But even this exercise proves little, and evidence of the opposite interpretation was essentially ignored.⁴⁰

³⁵ Bratton, *Rules Versus Principles Versus Rents*, *supra* note 34.

³⁶ *See supra* text accompanying note 15.

³⁷ For example, FASB and others point to its rules on derivative financial instruments as illustrating the obsessively detailed rules based approach, though FASB notes this quality largely reflects the complexity and variety of the underlying instruments to be accounted for. FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS) ____ : ACCOUNTING FOR DERIVATIVES (____ 200_).

³⁸ On the other hand, academic research in accounting supported the view that using principles rather than rules can promote conservative accounting and discourage aggressive accounting. *E.g.*, Andrew D. Cuccia, Karl Hackenbrack & Mark W. Nelson, *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 THE ACCOUNTING REVIEW 227 (1995); Dennis R. Beresford, *It's Time to Simplify Accounting Standards*, 187 JOURNAL OF ACCOUNTANCY 65 (1999).

³⁹ *E.g.*, Frederick Gill, *Principles-Based Accounting Principles*, 28 N.C.J. INT'L L. & COMM. REG. 967, 972 (2003). In fact, Sarbanes-Oxley itself invites comparing US GAAP with UK GAAP. Sarbanes-Oxley Act of 2002, § 108(d) Pub. L. No. 107-204, 116 Stat. at ____ ; 15 U.S.C. ____.

⁴⁰ Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 U. CONN. L. REV. 915, 976 (2003) (surveying a leading three-volume treatise, published by Palgrave and sponsored by KPMG, detailing the major accounting principles of 19 countries plus the EU and IASC and finding that in total pages devoted to these systems, a proxy for prescriptive density, US GAAP comes in fifth place—after the UK, Germany, Japan and France). Furthermore, rule characteristics develop by accretion of authoritative interpretation of principles, making relatively older systems such as US GAAP appear more rule-bound than relatively new

The dominant assumption of rules-domination, accompanied by these positive explanations for this condition, were set against a normative background concerning whether what FASB wrought was optimal. At a practical level, compared to general accounting principles, detailed accounting rules may be more difficult to use, costly to implement and—most poignantly—allow for structuring transactions to meet literal requirements while ignoring intent and spirit (read, to commit fraud). Advocates of a principles-based approach argued that it facilitates superior reporting and—most to present purpose—facilitates achieving a fair presentation when complying with GAAP.

A practical solution urgently was needed. A crisis loomed: if the widely-held assumption of GAAP as rules-excessive were true, then GAAP had to be reinvented—*post haste*—and the standard form of audit letter rewritten. After all, complying with that kind of GAAP would frequently mean absence of a fair presentation. If a fair presentation is privileged, then a rules-based GAAP makes itself functionally irrelevant. Fortunately, despite the weight of rhetoric, the unexamined assumption turned out to be false.

1. *Classifications* —What are rules and principles and how do they differ?⁴¹ Consider some automobile-driving concepts. Examples of driving rules are no-right-turn-on-red, no U-turns, red-means-stop and green-means-go, use turn signals, stop for school buses and wear seat belts.⁴² Principles are yellow-signals-caution, drive as a reasonable, prudent person and exercise due care in relation to driving conditions one faces. A rational system of driving-licensing and operation involves both sorts of directives. It is neither rules-based nor principles-based.

In accounting, rules begin with: a set of general purpose financial statements contains a balance sheet and income statement. Balance sheets record certain assets and most liabilities and show the difference as owners' equity; the income statement shows how business activity drives changes in owners' equity, by recording items of revenue and associated items of expense to aggregate a period's net income (or loss). Principles concern determining those other assets and some liabilities not appearing on a balance sheet and ascertaining the association between items of expense and revenue.

To unpack these broad examples, rules include specifying as assets accounts receivable and as expenses charge-offs associated with receivables-generation. Examples

systems such as International Accounting Standards. See Mark W. Nelson, *Behavioral Evidence on the Effects of Principles- and Rules-Based Standards*, ACCOUNTING HORIZONS (2003) [hereinafter Nelson, *Behavioral Evidence*].

⁴¹ A common formulation distinguishes rules from principles and then treats the aggregation of all these as standards. See Nelson, *Behavioral Evidence*, *supra* note 40.

⁴² Compare Louis Kaplow, *General Characteristics of Rules*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 502-528 (2000).

of possible rules might be that the allowance for doubtful accounts should be set at 5% of receivables generated during normal times, 3% during economic booms, and 8% during economic busts; a principle governing the allowance for doubtful accounts would direct making a reasonable estimate of probable charge-offs in the light of past experience in the business and its industry (what GAAP provides). An example of a principle might be to associate expenses with revenue in a reasonable manner; a rule-approach to this topic is that disbursements to acquire resources used up during an accounting period are expenses of that period (what GAAP provides).

These examples are representative of GAAP.^{38A} The excursion shows two things. It shows how difficult it is to prove that GAAP is rules-based or principles-based. And it shows, as with the examples of automobile-driving concepts, that GAAP is, in fact, a mixture of the two. In an elaborate study required by the Sarbanes-Oxley Act, the SEC confirmed this conclusion and thus resolved the (false) debate.

2. *Resolution* — The SEC found that existing GAAP is a mixture of rules and principles.⁴³ It declared the mixture substantially effective, and renamed it an objectives-based system.⁴⁴ The SEC study indicated that under such a system there should be limited need ever to indulge a GAAP override.⁴⁵ Complying with an objectives-based GAAP yields “fairly presented” financial statements. This conclusion thus resolved what otherwise loomed as a crisis: that GAAP would have to be scrapped if it could not promote a fair presentation.

The SEC’s elaborate study of the rules-principles dichotomy shows the dichotomy’s falsity. The SEC ultimately expresses the view that US GAAP is a mix of principles and rules and designates neither as superior. Instead it embraces what it believes to be a hybrid, which it calls an “objectives-based” system. It boils down to a different name for the prevailing mix of rules and principles, all intended to promote financial statements that “fairly present” financial condition and performance. This

^{38A} See also Nelson, *Behavioral Evidence*, *supra* note 40 (providing additional examples).

⁴³ See SECURITIES AND EXCHANGE COMMISSION, STUDY PURSUANT TO SECTION 108(d) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM, § III.G (undated; released 2003) [hereinafter SECURITIES AND EXCHANGE COMMISSION, PRINCIPLES-BASED ACCOUNTING STUDY].

⁴⁴ “Substantially” because the SEC’s key prescription directs FASB to link future accounting standards to its underlying conceptual framework as a way to promote this objectives-based concept, which the SEC indicates likely will incrementally produce results better characterized as principles than rules, though it does not regard the goal of producing more principles than rules as a primary objective. See *id.*

⁴⁵ Compare FIN. ACCT. STANDARDS BD. PRINCIPLES-BASED APPROACH TO U.S. STANDARD SETTING, *supra* note 4 (proposal to include a “true and fair view” override).

resolution of the false dichotomy is correct, but the struggle that went into it is also a false catharsis, for deeper issues unaddressed are at stake.⁴⁶

At a more practical level, FASB's statutory-like approach to accounting was intended to enable accounting's promulgators to respond to emerging issues and thwart observed abuses. A limited capacity to anticipate managerial reactions to these regulatory responses produces bias favoring rule-like pronouncements rather than principles. This can create another problem: rules create cracks for exploitation. On the other hand, accounting's natural language origins cannot be squelched and, when accompanied by brooding concepts such as fairly presents, forge congruity between accounting and fair presentations. The reservoir of accounting concepts—code and natural language alike—are abstractions requiring concrete circumstances for their particularization.

Modern lawyers will recognize the false dichotomy in the rules-principles debate, bearing echoes of contemporary discourse on the merits of legal positivism. Legal positivism treats law as a system of rules. H.L.A. Hart's legal positivism contained a theory of law and an account of adjudication.⁴⁷ In it, law is a matter of rules, divided into two types: primary rules stating duties or rights and secondary rules that regulate their application (including the rule of recognition, a norms-based conception against which the validity of all secondary and primary rules is gauged in terms of social acceptance). Hart held that law's use of language as expression invited judicial interpretation, constrained through a conception of law as carrying an uncontroversial core component along with a more contentious penumbra where discretion is exercised.

Modern legal theorists dating to Holmes doubted this conception, observing judicial discretion even in the face of the most clearly defined legal concepts as rules. Ronald Dworkin most successfully presented the more capacious conception of law as

⁴⁶ The SEC may believe it ushered in a new regime. *See supra* note 44. In fact, some regard contributions to the rules-principles debate as a major effect of Sarbanes Oxley. *Compare Coffee, Gatekeeper Failure and Reform, supra* note 30, at 342-43:

Sarbanes-Oxley ushers in and accelerates a major and probably inevitable transition, which will move us from a rules-based system of financial disclosure to a principles-based system. In contrast to Europe, the United States has long relied on a rules-based system in which generally accepted accounting principles (or "GAAP") were precise, technical, and limited. Typically, these narrow rules afforded safe harbors from liability for issuers and gatekeepers. In contrast, European accounting principles were broader, more generalized, and sometimes indefinite to the point of being ineffable.

⁴⁷ H.L.A. HART, THE CONCEPT OF LAW.

including not only rules but also principles.⁴⁸ These provide a spirit to law that guide judges and others in applying rules. The principles are not necessarily instances of natural law or morality, but are a feature of law to be interpreted. Law is thus a seamless web of rules and principles, making positivism an impoverished account. Judicial interpretation is not (only) a function of law as language with cores and penumbras but a function of interpretive practice. Properly conducted, legal interpretation yields a correct answer to any legal issue.

Whatever view a legal theorist holds on the critique of legal positivism, the critique applies more forcibly to accounting as positive code. First, in accounting moral conceptions are more attenuated. The spirit may be discernable, expressed in concepts of fair presentation, but it is not a question of the natural moral order. Second, primary and secondary concepts may be identifiable—a primary rule is to record revenue when earned and a secondary rule is to achieve a fair presentation. But any equivalent to a rule of recognition the accountant or auditor faces is hardly a function of social acceptance; at best it is a matter of general acceptance within the profession and possibly among market participants. Third, accounting is far more akin to a seamless system of rules and principles. Despite discretion, moreover, even Herculean accountants might, in about the same way as Herculean judges, be expected to reach correct results, at least in the sense of achieving a fair presentation.

Law and accounting—in both code- and non-code-based form—involve abstraction of the particular and particularization of the abstract.⁴⁹ At maximal generality, everything in the universe—or a given universe—is the same. In case law, every case is of the form plaintiff versus defendant. This label is meaningless for its lack of discrimination. At maximal specificity, everything is different. In cases, *Brown v. Smith* tells something only about that particular case, meaningless due to its hyper-granularity. Case analysis searches for the normatively-significant features of the case, such as buyer versus seller for breach of warranty contained in a contract for the sale of goods. This is combining particularity with generality to achieve normativity;⁵⁰ this is the activity of the accountant in determining how to apply GAAP to particular transactions so that resulting financial statements are fair presentations of business reality.

⁴⁸ RONALD DWORKIN, *TAKING RIGHTS SERIOUSLY* (1973); RONALD DWORKIN, *LAW'S EMPIRE*.

⁴⁹ See Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 814-19 (1985) (showing mutual dependency between law's conception of freedom of contract and the philosopher's social contract. in the dual process of abstraction of the particular and particularization of the abstract).

⁵⁰ See Gregory M. Silverman, *Imperatives, Normativity, and the Law*, 31 CONN. L. REV. 601 (1999).

Consider the relation between statutory (or regulatory) and common law. Statutory (and regulatory) law can be drafted as neat, clean, and clear. The appearance is deceiving, however, because rules are studded with loopholes and ambiguities.^{50A} The common law must be distilled, discerned, worked-over; it is understood as a capacious system, and though prone to cracks, operating to seal the cracks are a variety of formal institutional devices, including accepted modes of reasoning such as by analogy, principles of *stare decisis* and precedent, and the recognition of appropriate institutions and processes to make it operational.⁵¹ This complex process takes time. Accounting as code and natural language bears similar characteristics; making GAAP a coherent system likewise requires time. But accounting, as we will see, increasingly lacks the luxury of time. And this is the fatal feature of the current accounting condition.

II. NUMERICAL HISTORY AND ITS DISCONTENTS

Traditional accounting is largely numerical history. An overarching accounting concept holds that only transactions that have occurred are recorded. Accounting is quintessentially history. Another holds that only transactions measurable in monetary units are recorded. Accounting is quintessentially numerical. These basic propositions, rooted in accounting's ancient natural language and unchanged by its modern codifiers, are assumed in all interesting questions of accounting theory. In related debates, however, pressure increasingly appears to jettison these basics, sewing acorns for an oak-sized movement away from accounting as numerical history and towards a far more ambitious function as narrative prognosis.

A. *The Basic Statements*

Accounting's traditional chief vehicles to express numerical history are the balance sheet and income statement. A traditional debate in accounting theory considers the relation between these two archival documents as tools to capture what has occurred. A central question of accounting theory is whether the balance sheet and income statement are both necessary components of a set of general purpose financial statements.

It is possible to record all transactions only in the balance sheet (revenues increase owners' equity and expenses reduce owners' equity). In theory, at least, it is possible to record all transactions in the income statement and ignore the balance sheet. The same measurements are used in both reports (in accounting parlance, they *articulate*): the difference between revenues and expenses constitutes earnings and this amount is equivalent to the period's change in owners' equity.

^{50A} See Alexander & Sherwin, *The Deceptive Nature of Rules*, *supra* note 20.

⁵¹ See Robert S. Summers, *How Law is Formal and Why It Matters*, 82 CORNELL L. REV. 1165 (1997).

Consider two views of the conceptual underpinnings. The balance sheet view sees revenues and expenses as resulting from changes in assets and liabilities (revenues are asset increases and/or liability decreases while expenses are asset decreases and/or liability increases). The income statement view sees earnings as the key, with assets and liabilities as residual holding places for the results of operating activities driving revenues and expenses.

FASB and the SEC take the balance sheet view.⁵² The balance sheet view emphasizes measuring owners' equity and changes in it (earnings simply drive this) while the income statement view emphasizes measuring earnings (assets and liabilities are just residuals; this places greater emphasis on accounting's accrual concept and matching principle, the idea that revenue should be recorded when earned and all items of expense incurred to generate it be matched to the period in which it was earned).⁵³

Heuristics are invoked to defend using both documents, whichever one is deemed superior. The balance sheet is a statement of position (a snapshot, as of a date) and the income statement is a statement of performance (a motion picture, for a period of time). These images help explain why both documents are useful, but these images also show the limits of each: they both look backward and use the same measurement concepts. This invites an alternative possibility: finding a way to overcome these limits to improve the qualities of both so that neither is superior to the other.

This possibility unfolds debate in a different direction, envisioning for accounting a more ambitious role than numerical historian. This view admits that both statements may be useful because they provide different perspectives, but contends that their unified measurement means they essentially tell the same thing. If so, the documents are essentially redundant due to an unnecessary urge for articulation (using the same measurements for both).

To provide non-redundant information, assets and liabilities could be defined and measured solely in reference to the balance sheet and revenues and expenses solely in reference to the incomes statement. Different measures would be used for each statement, shedding compulsion for articulation. This view is supported by the claim that when you try to force articulation you get owners' equity and earnings figures that bear no indication of actual worth (value). Permitting non-articulation could enable owners' equity and earnings figures to indicate value.⁵⁴ This argument reflects desire to move accounting away from its historic-numeric model and towards a model of different utility: to provide information about value, a prospective-looking conception.

⁵² See SECURITIES AND EXCHANGE COMMISSION, PRINCIPLES-BASED ACCOUNTING STUDY, *supra* note 40.

⁵³ The next section discusses accounting's accrual concept and matching principle further.

⁵⁴ See RIAHI-BELKAOUI, ACCOUNTING THEORY, *supra* note 12, at 126-133.

Whether this ambition should be pursued is uncertain. To be ready for such service, accounting's fundamentals would need to be sturdier than appears possible. One must be able to walk before one can run and accounting has enough difficulty walking. A related fundamental question of accounting illustrates. When accounting choices entail a recording system producing greater fidelity in the balance sheet or the income statement, to which statement should the choice be more faithful?

Take accounting for inventory, on which GAAP offers choices.⁵⁵ Leading alternatives are to assume goods flow through a business on a first-in-first-out (FIFO) basis or a last-in-first-out basis (LIFO). During inflationary periods, the FIFO assumption is more faithful to economic reality in the balance sheet (current assets are recorded at current levels but current cost of sales are recorded at outdated levels) while the LIFO assumption is more faithful to economic reality in the income statement (costs are recorded at current levels while assets are recorded at outdated levels).

In which statement should greater faithfulness be promoted? Most users of financial information—as well as accountants, managers and auditors—regard the income statement as more useful than the balance sheet.⁵⁶ If so, when trade-offs arise in relative fidelity between the respective statements and economic reality, the alternative should be chosen that promotes greater fidelity in the income statement than in the balance sheet.⁵⁷ So a good measure of income should be privileged over a good measure of owners' equity (income statement over the balance sheet). In inflationary periods, this means LIFO should be preferred to FIFO (and this appears reflected in the proportion of companies choosing it).

Ambitious accounting theorists seek a way to enable using LIFO in the income statement and FIFO in the balance sheet. As it exists, GAAP calls for articulation between the two reports. That is, revenues minus expenses equal earnings and this amount determines changes in owners' equity. So the same method of determining the cost of goods sold and inventory must be used in both statements. Allowing the two to bear different measurements (that is, to allow for non-articulation) would improve fidelity to economic reality. But, coming to the point, this does not imply that it would facilitate superior valuation exercises.⁵⁸ Superior accounting is superior numerical history, not superior utility for forward-looking valuation exercises.

⁵⁵ Notice how this is neither a standard nor a rule. *Compare supra* Part I.B.

⁵⁶ This is the case for going concerns as opposed to business liquidations.

⁵⁷ Again, the case for going concerns as opposed to business liquidations.

⁵⁸ The non-articulation view was once supported by the American Accounting Association, the professional association of academic accountants. Permitting non-articulation between the income statement and balance sheet would presumably call for a statement of reconciliation between the two.

A related cardinal principle of accounting further illustrates the difficulty accounting faces on its own numerical-historical terms. The concept is conservatism, meaning a preference when judgments are close for understanding assets and revenues and overstating liabilities and expense. As between LIFO and FIFO, LIFO may be more conservative in both the income statement and the balance sheet for any given period. But conservatism in the balance sheet, showing lower ending inventory, entails less conservatism in the succeeding period's income statement, showing lower expenses.⁵⁹ So accounting faces inherent trade-offs on its own terms, with fundamental concepts such as conservatism providing conflicting answers to basic questions.

This discourse on FIFO-LIFO shows it may be more useful to concentrate on accounting's integrity as numerical history before attempting to position it in more ambitious roles. In the example, using FIFO or LIFO drives different reports of net income and assets. The same is true for thousands of accounting questions, which cannot be constrained by rules, principles, or fairly-presents requirements.

This prompts a simple (but revolutionary) proposal: to abandon the conceit of computing a single number for earnings and a single number for owners' equity and instead report a range of reasonable figures for each.⁶⁰ This would more fairly reflect the fundamental challenges and limits of accounting, a system tied to numbers and history yet still capable only of providing ranges with any reliability. Despite these realities, demands on accounting increasingly push in opposite bolder directions, as the following examples show.

B. Historical Cost or Fair Value?

Debate on the relative utility of the balance sheet versus the income statement, and their articulation, shows accounting's historic-numeric orientation. Associated limits appear more fully by considering accounting for fixed assets (those with useful lives covering multiple accounting periods). These are recorded at historical cost (less

⁵⁹ This also affects the inventory turnover ratio, a key measure of business performance that relates sales to the cost of sales: a company using LIFO rather than FIFO will show, other things being equal, speedier inventory turnover.

⁶⁰ The proposal's appeal is invariant to whether a rules- or principles-framework dominates, and indeed reinforces the sense that this is a false dichotomy. Put in those terms, a rule is $2 + 2 = 4$. There is no other correct answer to this question, what is $2 + 2$. A standard may be $.33 + .33 + .33 = 1$. The issues in accounting are more fundamental than should we keep a rule that says $2 + 2 = 4$ or adopt a standard allowing $2 + 2$ to equal other sums under certain circumstances. The issue is how to determine whether the inputs are 2 and 2 versus 1 and 3. As the FIFO-LIFO example suggests, a fair answer would be we are only certain that the inputs are either 2-and-1 (or in between) or 2-and-3 (or in between) so that the result fairly ranges from 3 to 5. This trade-off characterizes nearly all accounting exercises.

accumulated depreciation taken as a periodic expense, for most fixed-assets). Most transactions other than those concerning fixed assets are recorded at fair value (inventory is recorded at the lower of cost or market, with cost capturing pretty much current costs given that inventory is a current asset). Should fixed assets be too?

In periods of changing prices, the historical-cost principle applied to fixed assets diminishes the fidelity of reported amounts to current economic reality. Suppose a company bought an acre of land 20 years ago for a cost of \$100,000 and a contiguous functionally identical acre today for \$1 million.⁶¹ Its balance sheet would show a total for these of \$1.1 million (land is not subject to depreciation exercises—a rule). But the figures suggest a total current value for them of \$2 million. The historical cost principle thus carries an embedded assumption that currency amounts are a stable unit of measurement like gallons, tons, or miles. This assumption is false whenever average price levels change.

For short periods of relatively stable prices the stable-currency assumption may not matter much. But over short periods with rapidly changing price levels or long periods with modest period-to-period changes, the assumption renders comparisons difficult. In the aftermath of the hyper-inflationary period of the 1970s, FASB flirted with concepts that would reflect inflationary effects on fixed asset carrying amounts. It experimented with requiring large entities to report supplementary data concerning the effects of inflation on current values and current replacement costs. The experiment revealed that the costs of computing and supplying such data outweighed associated benefits and the requirement was repealed.⁶²

Despite this experiment's failure, advocates of more ambitious goals for accounting seek a fair-value approach.⁶³ This fair-value movement favors reporting all

⁶¹ See ROBERT LIBBY, *ET AL.*, FINANCIAL ACCOUNTING (3rd ed. 2001), at ____.

⁶² See American Bar Association Securities Regulation Subcommittee on Annual Review, *Significant 1986 Regulatory and Legislative Developments*, 42 BUS. LAW. 827, 871-72 (1987) (noting 1986 repeal of FASB inflation accounting statement in effect during the latter 1970s and adjustments to related SEC rules formerly requiring certain large public companies to provide supplementary financial information on the impact of inflation).

⁶³ See Stanley Siegel, *The Coming Revolution in Accounting: The Emergence of Fair Value as the Fundamental Principle of GAAP*, 42 WAYNE L. REV. 1839 (1996); see also G. A. Swanson, *Accountability and the Drift Towards 'Fair Value Measurement'*, AM. ACCT. ASS'N REGIONAL MEETING PAPER, SSRN ID = 487043 (Apr. 6, 2004); see generally FIN. ACCT. STNDS. BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 7, USING CASH FLOW INFORMATION AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS (Feb. 2000).

assets on the balance sheet at fair value. The key reason for recording fixed assets at historical cost is this provides an objective measure under the monetary transactions principle; the key reason not to use fair value is conservatism. Fair value could be reported using appraisals or comparable transactions, but the remaining subjective element puts it in tension with the conservatism principle (when in doubt, understate assets). Also the benefit may be modest, since users of balance sheets read them later than the balance sheet date and by then fair value may have changed.⁶⁴

But reporting some assets at historical cost and others at fair value produces a total asset figure consisting partly of oranges and partly of apples.⁶⁵ An alternative proposal exhibiting more modesty meets this objection. It asks whether accounting needs a statement reporting fixed assets at all.⁶⁶ Suppose a different statement of position/condition than the balance sheet, such as a “statement of solvency.” It would show all resources and claims susceptible to objective measure and denominate the difference between the two as a measure of solvency (the capacity to meet long term obligations when they come due).

Financial statement analysts distinguish liquidity, capacity to meet short-term obligations, from solvency, capacity to meet long-term obligations. Beyond that, however, solvency is rarely discussed in accounting literature, though frequently analyzed in law.⁶⁷ A solvency statement would be like a balance sheet in capturing a moment in time. In contrast, it would only report those assets that can be measured at fair value. This would exclude most fixed assets (as well as most intangible assets). They can be reported in the notes.⁶⁸

⁶⁴ Limits of using the historical cost principle for fixed assets is another argument for income statement supremacy over the balance sheet. On the other hand, given articulation between the two, limits on the balance sheet imply limits on the income statement. Moreover, examining the concept of accumulated depreciation leads to the same dead-end. It can be a useful proxy for required reinvestment. Reporting fixed assets at fair value and tying depreciation expense to that amount would enhance the reliability of accumulated depreciation as a proxy. True, depreciation would remain principally a cost-allocation exercise implementing the matching principle. But for long-held assets during inflationary periods, its utility as a proxy for required reinvestment would improve. The trade-off is between reliability and usefulness: fair values may be more useful but absent actual markets where those values are registered they may be less reliable.

⁶⁵ See Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOKLYN L. REV. 763, 826-834 (1995) [hereinafter, Kitch, *Theory and Practice*]. There is nothing wrong with adding apples and oranges but the result is a basket of fruit, difficult to compare with other fruit baskets.

⁶⁶ See ANTHONY, *RETHINKING THE RULES*, *supra* note 11, at ch. 3.

⁶⁷ See *id.*

⁶⁸ See *infra* Part II.A.1.

The solvency-statement proposal and fair-value movement straddle existing balance sheet norms. In effect, the balance sheet compromises a tension between measuring the immeasurable (objective fair-value estimates for fixed assets) and unifying what cannot be unified (apples and oranges). The solvency concept recognizes measurement limits by limiting reported asset amounts to those susceptible to objective measurement. The fair value movement reflects frustration with accounting's traditional orientation towards history, seeking a more current orientation. This view reflects a more general climate of frustration with accounting's historic-numerical disposition, epitomized ultimately by making cash a rival to accrual accounting.

C. Accrual or Cash?

Accounting as natural language and as code uses the accrual system. This allocates economic events to discrete accounting periods based upon a link to underlying business activity. It contrasts with the cash-basis of accounting, which records events when cash is exchanged. The accrual system's theoretical basis includes the stewardship function of accounting information, a fundamentally historical perspective. Financial reports should reflect how well managers have operated a business. The accrual system's key device, the matching principle, pursues this aspiration by insisting that expenses burden the income statement in the period they contribute to revenue generation (or earlier if this cannot be determined, under the conservatism principle).

In the past two decades, a separate statement of cash flows has joined the balance sheet and income statement as an essential component of a set of general purpose financial statements.⁶⁹ The accrual system obscures cash flows; the cash flow statement makes them transparent. Financial statement analysts and finance theorists increasingly focus on cash flows, casting doubt upon the utility of the accrual basis of accounting. Consider the following assertion: cash flow is a fact, while earnings are an opinion. This assertion is from the title of an important article by a leading financial economist.⁷⁰ The provocative title implies numerous points, two of which are notable here.

⁶⁹ FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS) 95: STATEMENT OF CASH FLOWS ¶ 27 (Nov. 1987); Cunningham, *An Essay on the True and Fair View*, *supra* note 25 (providing historical perspective).

⁷⁰ Pablo Fernández, *Cash Flow is a Fact; Net Income is Just an Opinion* (Sept. 2002), http://papers.ssrn.com/abstract_id=330540. A famous contemporary debate in accounting theory evaluates whether valuation according to earnings or cash flows is superior. Compare Stephen Penman, *On Comparing Cash Flow and Accrual Accounting Models for Use in Equity Valuation*, 18 CONTEMP. ACCT. RESEARCH (2001) (the case that accounting matters and that accrual-earnings based valuation models are superior to cash flow models) with Russell J. Lundholm & Terry O'Keefe, *On Comparing Cash Flow and Accrual Accounting Models for Use in Equity Valuation: A Response to Penman 2001*, 18 CONTEMP. ACCT. RESEARCH (2001) (when applied correctly, valuation models using earnings and cash flow should yield identical estimates).

First, the cash flow statement's power opens up possibilities for accounting never plausible with the balance sheet and income statement alone. Cash flows are a more reliable tool than traditional accounting data drawn from balance sheets and income statements in predicting bankruptcy filings under Chapter 11 of the US Bankruptcy Code and insolvency generally.⁷¹ Evidence suggests that the cash flow statement is superior compared to the balance sheet for measuring accruals as a way to test for the presence of earnings management in the income statement.⁷² Past cash flows are usually a better indicator of future cash flows than are earnings (though predictions can be improved by using the two together).

Second, the leading use of the cash flow statement is a basis for making valuation determinations. And the leading basis for making valuation decisions is cash flow.⁷³ In fact, discounted cash flow (DCF) valuation became, in the latter half of the 20th century, the dominant valuation method, rendering to history's dustbins traditional valuation using assets or earnings. Despite resistance through the early 1980s,⁷⁴ DCF is now routinely used to gauge business value. Institutions ranging from U.S. courts to the World Bank endorse DCF valuation methods.⁷⁵

Two features of valuation emphasizing cash flow stand out. First, what constitutes cash flow must be specified. On a cash flow statement the amounts are usually specified—they can be facts—but when analyzing them a wide variety of possibilities

⁷¹ See DIVESH SHANKAR SHARMA & ERROL R. ISELIN, THE DECISION USEFULNESS OF REPORTED CASH FLOW AND ACCRUAL INFORMATION IN A BEHAVIORAL FIELD EXPERIMENT, *available at* <http://www.ssrn.com>.

⁷² See Gopal V. Krishnan & James A. Largay, *The Predictive Ability of Direct Method Cash Flow Information*, 27 J. BUS. FIN. & ACCT. 215 (2000).

⁷³ See *e.g.*, ZVI BODIE & ROBERT C. MERTON, FINANCE (2000); RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE (4th ed. 1991); WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS (5th ed. 2002); *compare* BRUCE C.N. GREENWALD, *ET AL.*, VALUE INVESTING (2001) (the case against making discounted cash flow analysis the dominant valuation method in favor of emphasizing asset-based valuation or earnings-based valuation).

⁷⁴ *Compare Weinberger v. UOP, Inc.* 457 A.2d 701 (Del. 1983) (abandoning previous business valuation framework reliant upon a weighted average of value estimated using assets, earnings and market price, in favor of framework permitting all generally recognized valuation methods, the ascendant one of which was DCF).

⁷⁵ See *M.G. Bancorporation v. Le Beau*, 737 A.2d 513, 523 (1999); WORLD BANK, REPORT TO THE DEVELOPMENT COMMITTEE AND GUIDELINES ON THE TREATMENT OF FOREIGN DIRECT INVESTMENT, Sept. 21, 1992, 31 I.L.M. 1363,1379 (1992).

appear. They all start with GAAP earnings but then exclude or include a host of discretionary items.⁷⁶ Resulting expressions (like EBIT, EBIDTA and so on) are not accounting concepts. They do not appear in accounting's natural-language history nor in its FASB-codifications.⁷⁷ Rather, these concepts are recent inventions of investment bankers and other financiers.⁷⁸ Using them thus requires narrative evaluation and explanation. Second, DCF analysis projects cash flows into the distant future, at least five years and usually for a horizon period beyond that of 10 to 15 years.⁷⁹ Popularity of DCF thus underlines a shift in accounting information from accounting as numerical history to accounting as narrative prognosis.

III. NARRATIVE PROGNOSIS AND ITS LIMITS

If you sold 5 widgets last year, it is clearly a lie to report selling 6. If you say you expect to sell 6 widgets next year, it is not clearly a lie to say you hope to sell 7. This is a key difference between accounting as numerical history and accounting as narrative prognosis. The former is about facts; the latter is about hopes and expectations.

Two salient features of the late 1990s bubble were proliferation of analyst earnings reports specifying expectations and corporate *pro forma* reporting expressing hopes. Both phenomena show indulgence of accounting as narrative prognosis, not numerical history. Analysts expect certain results, an inherently prospective concept.⁸⁰

⁷⁶ Common short-hands include earnings before interest and taxes (EBIT), earnings before interest, taxes and depreciation (EBITD), and earnings before interest, taxes, depreciation and amortization (EBITDA). In each case, adjustments are made by subtracting from resulting cash-flow figures estimates of future required reinvestments in the business for capital expenditures.

⁷⁷ In fact, FASB-ordained GAAP prohibits providing cash flow per share figures in a set of general purpose financial statements. See FIN. ACC. STANDARDS BD., RELEASE ____.

⁷⁸ See H. Erik Lee & Heidi Lee, *Multiples Used to Estimate Corporate Value*, 58 FIN. ANALYSTS J. ____ (March/April 2002).

⁷⁹ See CUNNINGHAM, INTRODUCTORY ACCOUNTING, FINANCE AND AUDITING FOR LAWYERS, *supra* note 17, ch. 12 (discussion of valuation techniques, including DCF).

⁸⁰ The rise of this analyst function is a significant inimical phenomenon impairing accounting's integrity. The regulatory response, Regulation FD, went to a different perception of the problem: equal access to management. See D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and Its Impact on Market Participants*, 77 IND. L. J. 551 (2002). The real issue is the information to which access is given, which is not hard historical numbers but soft future-oriented narration. It was called "guidance." See *infra* text accompanying notes ____-____.

Managers peddling *pro forma* data understood they were not talking about numerical history but offering something else—hope.⁸¹

A common feature of accounting fraud is rosy views of the future. A manager believes certain targets can be reached—expecting 6 and hoping for 7. The future reporting of numerical history will be superior—better than 5. This can create sufficient optimism to doctor current pictures of numerical history (call it 6 this year), with a view towards the rosier future absorbing the difference between actual history and the imagined future (if we in fact sell 5 this year but 7 the year after, call it 6 apiece).⁸² Moreover, since no actual sales or receivables have been generated, and no inventory sold, there are no hard numbers to report, only estimates; and estimates must be explained, requiring narrative (we expect to sell 6 because of a new customer and hope to sell 7 because of a new manager).

As greater emphasis is placed on the future, the temptation to pursue this course increases. And the closing decade of the 20th century produced wide-scale social preoccupation with the future.⁸³ This preoccupation is evident in financial reporting and disclosure, in which accounting is the heart. Along with the rise of discounted-cash-flow valuation techniques, manifestations of analyst expectations and *pro forma* hopes were

⁸¹ The practice of *pro forma* financial reporting became widespread in the late 1990s and early 2000s. This involved presenting financial data in forms deliberately varying from GAAP. While managers defended these using various obfuscating arguments, including that GAAP just didn't work well for their special business, underlying it was an impulse to show how the future would likely look. It was an attempt to be liberated from GAAP, but more because of its inherent qualities as numerical history. Managers—and investors—wanted information bearing more futuristic utility. The misleading proliferation of *pro forma* accounting in the late 1990s spawned a section of Sarbanes-Oxley cracking down on its proliferation. Sarbanes-Oxley Act of 2002, § 401(b), Pub. L. No. 107-204, 116 Stat. at ___ ; 15 U.S.C. § 7266. But as with other reforms, this does not really get at the underlying issue concerning the impulse and demand for narrative prognosis rather than numerical history.

⁸² Cf. *In the Matter of BT Securities Corporation*, 58 S.E.C. DOCKET 1145, 1994 SEC LEXIS 4041 (Dec., 22 1994), reprinted in LAWRENCE E. MITCHELL, ET AL., CORPORATE FINANCE AND GOVERNANCE: CASES (2d ed. 1996), at 286. In this matter, tape recordings of a derivatives trader captured him describing how undisclosed losses on a client account would be made up when the market moved favorably, as follows:

. . . [T]he real number was 14. So now if the real number is 16, we'll tell him that it is 11. You know, just slowly chip away at that differential between what it really is and what we're telling him.

⁸³ See Anthony Giddens, *Risk and Responsibility*, 62 MOD. L. REV. 1 (1999) (contemporary risk management concepts showing increasing social preoccupation with the future).

part of broader changes forced on accounting's role, both antedating these manifestations and—ironically—sustained in reforms made in their wake.

A. Contemporary Evolution (*Pre-Scandal*)

Accounting reports have long been accompanied by narrative materials but the narrative component expanded dramatically during the latter 20th century.⁸⁴ In its final decades, moreover, the narrative platform became a basis for launching an expanding range of forward-looking discussion, making forecasts that revolutionized the nature of financial reporting. These trends reflect and fuel market demand for glimpses into the future.

1. *Narration* — Information provided in narrative is substantial compared to that provided numerically.⁸⁵ Financial statements are accompanied by elaborate narrative footnote disclosure explaining the accounting concepts applied and the significance of numerical data. Supplementary data often appears, likewise accompanied by substantial narrative explanation. Since the 1980s, federal securities laws require narrative management's discussion and analysis (MD&A) in addition to numerical presentation of accounting information. Using narrative information reflects both the limits of accounting's traditional numerical bias and demand for such qualitative accounting.

Numerous judgments enter into producing financial statements. These judgments are disguised by the numerical bottom lines, impressing the numbers with false scientific inevitability. Under accounting requiring specific numerical designations (as distinguished from the proposal made in Part II to provide a range of numbers),⁸⁶ their meaning must be expressed in narrative.

Consider how the balance sheet measures various assets according to differing metrics: fixed assets at historical cost less accumulated depreciation and other assets at fair value—with these subject to various conventions, such as inventory using FIFO or LIFO and accounts receivable net of an estimated allowance for doubtful accounts.

⁸⁴ Traditional accounting as numerical history contains hints of prognosis. For example, estimating bad debt expense associated with generating accounts receivable is prognostication as a forecast of probable recoveries. These estimates, however, are simultaneously constrained by the conservatism principle. *See supra* text accompanying note ____.

⁸⁵ This observation is unexceptional: balance sheets, income statements and cash flow statements are each either one or two pages long, while footnotes and management's discussion and analysis in typical annual reports extend for dozens of pages each.

⁸⁶ *See supra* note ____ and accompanying text.

These differences—apples and oranges—must be explained to make the data comprehensible for a company and comparable with its peers.⁸⁷

A key reason for narrative disclosure concerns the relation of the fair presentation requirement to GAAP's capacity, discussed in Part I. Accounting numeracy may be misleading, overall, unless choices are explained. This is the essence of SEC disclosure advice requiring an overall presentation that fairly presents performance and condition in all material respects.⁸⁸ Narrative disclosure often is essential to achieving this result. This is the case without regard to whether GAAP is living language or code, or whether founded upon rules or principles.

Narrative disclosure is also a way to include information not otherwise reported on the financial statements. Examples are endless: loss contingencies such as pending litigation and regulatory action, aging of accounts receivables, inventory measurements and obsolescence histories, depreciation schedules and so on.⁸⁹ This is also the approach FASB took to its inflation-accounting experiment of the 1980s, flirting with requiring supplementary disclosure concerning the effects of inflation on fixed asset carrying amounts using narrative to explain methodology.⁹⁰

The limits of numerical accounting appear in an AICPA proposal for a comprehensive model of accounting information disclosure.⁹¹ It would go far beyond the balance sheet, income statement and statement of cash flows, to embrace the kinds of

⁸⁷ Suppose Company A and Company B both report total assets of \$1 million. They appear similar. But suppose Company A's reported assets consist of \$900,000 of fixed assets (at historical cost less depreciation) plus \$100,000 in marketable securities (at fair value) while Company B's consist of the opposite mix. The total asset figures are meaningless. You need to know the mix. True, liabilities are typically carried at fair value (the present value of the obligation). But given the obscure asset side, the net worth or owners' equity figure is mythical. Return on equity is not comparable. Individual items are useful, while aggregates are not necessarily. See ANTHONY, *RETHINKING THE RULES*, *supra* note 12.

⁸⁸ See *supra* text accompanying notes ____ to ____.

⁸⁹ For a broader example, see Jeffrey Uneman, *Enhancing Organizational Global Hegemony with Narrative Accounting Disclosures: An Early Example*, 27 ACCOUNTING FORUM 425 (2003) (use of politically-oriented narrative accounting disclosure to enhance corporate power versus nation states).

⁹⁰ See *supra* text accompanying notes ____ to ____.

⁹¹ The AICPA is the American Institute of Certified Public Accountants. See EDMOND L. JENKINS *ET AL.*, *THE INFORMATION NEEDS OF INVESTORS AND CREDITORS* (1995) (report of an AICPA committee called the Jenkins Committee, after chairman Edmond L. Jenkins, then FASB Chairman) [hereinafter, JENKINS COMMITTEE REPORT].

narrative disclosure found in the federal securities laws. Accounting as numerical expression, confined to the basic financial statements, is inadequate. It must be explained using words.

An advantage to requiring narrative disclosure is comparative ease of generating appropriate directives, whether using principles or rules. A directive to “describe and explain” can be drafted and adopted quickly, compared to a set of principles or rules defining how a type of transaction is to be classified, measured and reported. A good recent example concerns off-balance sheet financing. SEC rules adopted promptly in the wake of early 2000’s scandal-revelations require descriptions of these when material.⁹² It would take far more time and elaborate process to specify the circumstances under which certain complex transactions need to be accounted for on the balance sheet and their effects on income.⁹³

A similar narrative approach is used to handle a wide variety of controversial accounting matters. Until mid-2004, FASB generally approached stock options by requiring narrative disclosure of their effects on earnings per share, not reported on the income statement.⁹⁴ Until the early 1990s, a similar approach was taken towards retiree benefit obligations.⁹⁵ Managers often prefer the narrative approach to such controversial

⁹² SECURITIES AND EXCHANGE COMMISSION, RELEASE NOS. 33-8350; 34-48960; FR-72, INTERPRETATION: COMMISSION GUIDANCE REGARDING MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (December 22, 2003).

⁹³ Resort to narrative disclosure likewise rounds out the rough edges of innovative reform proposals, including for example the statement of solvency concept discussed above, which would leave off the balance sheet most fixed assets as lacking objective-measurability, and reporting these instead in the notes. *See supra* text accompanying note ____.

⁹⁴ *See* CUNNINGHAM, INTRODUCTORY ACCOUNTING, *supra* note 16, ch. 6; *compare* FIN. ACCT. STNDS. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS) 148 ACCOUNTING FOR STOCK-BASED COMPENSATION—TRANSITION AND DISCLOSURE (an amendment of Statement No. 123) (requiring, after decades of intense resistance from corporate America, recording stock option as an expense on the income statement); *but see* HOUSE BILL, THE STOCK OPTION ACCOUNTING REFORM ACT (contemplating blocking adoption of this standard).

⁹⁵ *See* Kenneth E. Dakdduk & Jules M. Cassel, *A Guide to Implementation of Statement 106 on Employers’ Accounting for Post-retirement Benefits other than Pensions* (FASB, Aug. 1993; rev. ed. Dec. 98; rev. ed. Sept. 2001); FIN. ACCT. STNDS. BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS (SFAS) 106, EMPLOYERS’ ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS.

matters, showing that demand for narrative can arise not only from consumers of financial information, but from those who prepare it.⁹⁶

Demand from external users plays a significant role in generating narrative financial reporting. Traditional accounting's grammar, using monetary-units, is not susceptible to reporting non-financial matters. Consider the role of employees in firms. They are often a major "asset" in a sense (contributing to revenue-generating power); they do not appear on the balance sheet because the company does not "own" them. Narrative provides information on matters concerning employee training, recruitment/retention, investment and know-how.

In the same vein, consider for whom accounting information is prepared. Traditional financial statements are for external users, but this broad category tends to associate with creditors, shareholders and other commercial parties such as long-term customers or suppliers. Many other constituents claim interests and have informational needs not always met by traditional financial statements. Groups include employees, governmental agencies and public policy advocates. GAAP doesn't always give these consumers information they need and supplemental narrative is a way to compel (or volunteer) its production.⁹⁷

From yet broader policy perspectives, accounting information—in numerical and narrative form—coupled with mandatory disclosure, can be understood as seeking to promote equity in capital markets.⁹⁸ In this sense equity means the negation of

⁹⁶ Compare Anthony J., *Enron End-Runs*, *supra* note 4, at 102 (criticizing arguments favoring providing financial information in footnotes rather than in statements themselves as follows:

one must . . . question why various industries continue to fight with such vehemence against proposals to require the expensing of stock-based compensation if the same degree of transparency is being provided by virtue of footnote disclosure. The obvious answer is that the footnotes simply do not carry as much weight as the actual numbers in a balance sheet or income statement—the numbers on which various computations and ratios are often primarily based

⁹⁷ A dramatic example is social responsibility audits. There is no place for these in GAAP but they are increasingly popular or demanded. See David Hess, *Social Reporting: A Reflexive Law Approach to Corporate Social Responsiveness*, 25 IOWA J. CORP. L. 41 (1999); Lewis D. Solomon, *Implementation of Humanomics by Modern Publicly Held Corporations: A Critical Assessment*, 50 WASH. & LEE L. REV. 1625 (1993); see also Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999) [hereinafter Williams, *Corporate Social Transparency*].

⁹⁸ See Baruch Lev, *Toward a Theory of Equitable and Efficient Accounting Policy*, THE ACCOUNTING REVIEW (January 1988), at 1-22.

asymmetric information between insiders (management) and outsiders (investors and others) and erasure of the differences between informed and uninformed constituents. When these conditions exist, the market is fully-informed, and fairness optimized.

2. *Forward-Looking Emphasis* — Narrative disclosure is essential to provide the range of information detailed in the preceding section. Unlike numerical disclosure, however, narrative furnishes a convenient platform to launch into forward-looking discussion and analysis. Until the late 1970s, the SEC and federal securities law prohibited disclosure of forward-looking information.⁹⁹ In that period, market appetite for forward-looking information intensified.¹⁰⁰

Participants pressured the SEC to change its stance. After substantial resistance, the SEC finally relented, allowing forward-looking disclosure. Thereafter the SEC went further, encouraging and sometimes requiring forward-looking information.¹⁰¹ The SEC characterizes related disclosure as addressing “trends and uncertainties” in a business.¹⁰² This opens up accounting’s historical bias towards narrative prognosis.

Revisiting this debate’s history and terms is useful. The movement for forward-looking disclosure occurred at the same time as the movement for greater codification of GAAP discussed in Part I. In the early 1970s, SEC Chief Accountant John Burton, among others, challenged the newly-established FASB to improve the quality of accounting promulgations while simultaneously pushing for forward-looking

⁹⁹ See SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE OF PROJECTIONS OF FUTURE ECONOMIC PERFORMANCE, SECURITIES ACT RELEASE NO. 5362; EXCHANGE ACT RELEASE NO. 9984, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211 at 82,666 (Feb. 2, 1973) (“It has been the Commission’s longstanding policy generally not to permit projections to be included in . . . reports filed with the Commission”); SECURITIES AND EXCHANGE COMMISSION, GUIDES FOR DISCLOSURE OF PROJECTIONS FOR FUTURE ECONOMIC PERFORMANCE, SECURITIES ACT RELEASE NO. 5992 (1978) (authorizing forward-looking disclosure).

¹⁰⁰ E.g., Homer Kripke, *Can the SEC Make Disclosure Policy Meaningful?*, J. PORTFOLIO MGMT. (Summer 1976) at 32, 35-37.

¹⁰¹ See SECURITIES AND EXCHANGE COMMISSION, REGULATION S-K, ITEM 303, 17 C.F.R. § 229.10(b) (“The Commission encourages the use . . . of management’s projections of future economic performance that have a reasonable basis and are presented in an appropriate format.”); *id.*, 17 C.F.R. § 229.303(a)(3)(ii) (mandating disclosure of “any known trends or uncertainties that [management] reasonably expects will have a material favorable or unfavorable impact on . . . revenues or income from continuing operations”).

¹⁰² SECURITIES AND EXCHANGE COMMISSION, REGULATION S-K, ITEM 303, 17 C.F.R. § 229.303; see generally Quinton F. Seamons, *Requirements and Pitfalls of MD&A Disclosure*, 25 SEC. REG. L. J. 239 (1997).

disclosure.¹⁰³ Although these activists achieved limited success in improving accounting's qualities as numerical history, they unleashed a revolution in financial reporting by opening it up to narrative prognosis.¹⁰⁴

Opponents of forward-looking disclosure made three key arguments favoring the SEC's traditional stance prohibiting prognostication.¹⁰⁵ First, forward-looking statements are inherently unreliable and misleading *per se*.¹⁰⁶ No one is clairvoyant, and therefore management can be no more clairvoyant than investors or other users of financial reports. Second, investors likely would assign undue credence to formal managerial disclosure of forward-looking information, despite this inherent unreliability. Third, forward-looking information is susceptible to managerial manipulation to a far greater degree than is hard historical fact. All three objections have proven valid, underscored by the accounting frauds of the late 1990s and early 2000s.

Supporters of forward-looking disclosure emphasized that all investment valuation and related decisions are about the future, a point opponents did not and do not dispute. Disagreement concerned whether managers or investors are better positioned to conduct prognostication. While supporters did not believe either group was clairvoyant, they did opine that managers were somehow better equipped than investors to provide reasonable forecasts.¹⁰⁷ They also redefined the target audience for financial disclosure from the average ordinary investor to the sophisticated investor, an effort to negate the claim that investors would give undue credence to managerial forecasts.¹⁰⁸ Finally, manipulation risk could be neutralized by imposing on managers an obligation of good faith when providing forward-looking disclosure.¹⁰⁹

¹⁰³ John Burton, *Elephants Flexibility and the Financial Accounting Standards Board*, 29 BUS. LAW. 152 (1974) [hereinafter Burton, *Elephants and Flexibility*]; see also Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970) [hereinafter Kripke, *Myths and Realities*].

¹⁰⁴ See SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note 13, at 554-555.

¹⁰⁵ See Harry Heller, *Disclosure Requirements under Federal Securities Regulations*, 16 BUS. LAW. 300, 307 (1961) (despite reality that investment value is a function of future financial performance, managers are not clairvoyant and management attempts at forecasting are "almost invariably . . . misleading because they suggest to the investor a competence and authority which in fact does not exist").

¹⁰⁶ SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note 13, at 611.

¹⁰⁷ See Kripke, *Myths and Realities*, *supra* note 103.

¹⁰⁸ See Burton, *Elephants and Flexibility*, *supra* note 103.

¹⁰⁹ See Kripke, *Myths and Realities*, *supra* note 103, at 1198-99.

The debate's resolution led to a system requiring more and more forward-looking disclosure, with SEC releases in 1979, 1982 and 1989 increasing this orientation.¹¹⁰ Early proponents disagreed as to whether this regime should be voluntary or mandatory; the result was initially an experimental regime based on voluntary disclosure that gradually moved to one mandating specific kinds of forward-looking disclosure.¹¹¹ Also debated was whether forward-looking information should be targeted at the sophisticated investor or all investors. Supporters argued that managers provided forecasts to sophisticated investors outside formal SEC filings and that all should be entitled to this information.¹¹² While this reality was unchanged through the late 1990s, the SEC then adopted Regulation FD to require that any such guidance provided to one investor be provided simultaneously to the entire public.¹¹³

Regulatory efforts ensuing from this debate thus addressed numerous contentious questions. The resulting regime is mostly mandatory; good faith and reasonable bases are required; and all investors—sophisticated and novice alike—are entitled to the same predictions. Never resolved in this debate on the merits, however, is the argument of opponents that forward-looking information is inherently unreliable. It remains true, after all, that no one is clairvoyant. The late 1990s and early 2000s also show that even so-called sophisticated investors are not immune from being fooled by managerial manipulations.

Accordingly, the SEC's early cautious regulatory response to market demand for futuristic information showed prudence. The reality that forward-looking information is inherently unreliable manifested itself immediately. Managers would forecast various business developments for market participants eager to clarify their own cloudy crystal balls. When these judgments turned out differently, plaintiffs' lawyers sued. This litigation manifested symptoms of the underlying reality that forward-looking

¹¹⁰ See SELIGMAN, *TRANSFORMATION OF WALL STREET*, *supra* note 13, at 611 (SEC's 1982 adoption of Item 303 of Regulation S-K concerning MD&A and forward-looking information "is the key part of the evolution of the Commission's approach to accounting from an emphasis on 'hard fact' to its present emphasis on 'soft' or predictive information. It is a comprehensive disclosure item").

¹¹¹ See SELIGMAN, *TRANSFORMATION OF WALL STREET*, *supra* note 13, at 559-561.

¹¹² Compare Kripke, *Myths and Realities*, *supra* note 103 (objecting to extant practice that SEC position perpetuated of "differential disclosure," meaning professionals receiving projections in presentations, conference calls and press releases the public at large did not receive) with Burton, *Elephants and Flexibility*, *supra* note 103 (urging reorientation of SEC target audience from "the investor without clout, if you will" and "sophisticated investors and professional analysts through whom information would be filtered down to less sophisticated investors and their brokers").

¹¹³ SECURITIES AND EXCHANGE COMMISSION, *SELECTIVE DISCLOSURE AND INSIDER TRADING*, FINAL RULE: 65 FED. REG. 51,716 (2000).

information is inherently unreliable. Rather than ever confronting this reality squarely, the regulatory regime focused on these symptoms by designing devices to address associated litigation abuses.¹¹⁴

The leading device to address litigation abuses associated with forward-looking information is a body of safe harbor provisions that insulate issuers from liability in private actions when forward-looking statements are accompanied by cautionary language underscoring their basic unreliability. The SEC, Congress and courts all participated in developing related doctrines.¹¹⁵ The judiciary used the so-called bespeaks-caution doctrine,¹¹⁶ providing a case-by case evaluation of whether forward-looking information was accompanied by sufficient cautionary language to alert a reasonable investor to the information's tentative quality.¹¹⁷

¹¹⁴ See SELIGMAN, TRANSFORMATION OF WALL STREET, *supra* note 13, at 559-560 (quoting SEC official and leading securities lawyer of the period, A. A. Sommer, as saying that litigation aspects were the “biggest headache” associated with the new forward-looking disclosure regime).

¹¹⁵ See Securities Act Rule 175 and Exchange Act Rule 3b-6; Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 77z-2 (Section 27A of the 1933 Act) and 15 U.S.C. § 78u-5(c) (Section 21E of the 1934 Act). For a concise summary of the intricate provisions of the Private Securities Litigation Reform Act addressing the relationship between its safe-harbor provisions and the kinds of forward-looking information that are required, encouraged, and permitted, see Dale E. Barnes, Jr. & Karen Kennard, *Greater Expectations: Risk Disclosure Under the Private Securities Litigation Reform Act of 1995*, 2 STAN. J.L. BUS. & FIN. 331, 335-354 (1996).

¹¹⁶ See, e.g., *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357 (3d Cir. 1993); *Rubenstein v. Collins*, 20 F.3d 164, 167 (5th Cir. 1994); *Mayer v. Mylod*, 988 F.2d 635 (6th Cir. 1993); *Haris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999) (also interpreting Congressional and SEC safe harbor provisions); see generally Donald C. Langevoort, *Disclosures that “Bespeak Caution,”* 49 BUS. LAW. 481 (1994).

¹¹⁷ Courts provided varying formulations of the doctrine, though generally they applied to both misstatements and omissions, solely to prospective information, with particularized cautionary language related directly to the relevant disclosure. JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS (9th ed. 2003), at 1017-20 (summarizing cases and positions by circuit). In general, however, it is a pragmatic application of basic principles of securities law, chiefly designed to balance generating useful but contingent information against dangers that issuers could hide behind bad news by cloaking it in cautionary garb. See *Rubenstein v. Collins*, 20 F.3d 164, 167 (5th Cir. 1994).

While some evidence indicates that the forward-looking disclosure system enhanced the overall quality of information and its interpretation,¹¹⁸ drawbacks appear.¹¹⁹ When managers forecast future earnings, and equip analysts to do so and these widely disseminate expectations across the market-place, enormous pressure to meet those expectations arises. (When you sold 5 widgets, you created a historical record; when you say you expect to sell 6 and hope to sell 7, you have created expectations and hopes.) Managers who fail to meet expectations and hopes are punished severely. This in turn increases the pressure to enhance reports of numerical history to conform to the narrative prognosis previously painted.¹²⁰ The result is often snowball accounting: continuing pressure to repaint the numerical history to conform to increasingly out-of-reach narrative prognosis.

These effects are not met by regulatory efforts to police the litigation fallout from prognostication. More difficult than second-guessing by litigation is the first-order stage on which this information is demanded and supplied. Demand for forward-looking information is demand for what is inherently unreliable. Supplying the information sets markers that are bound to result in disappointment. Specifying the targets creates pressure to meet them, and when fundamental business strategies cannot do so, accounting massage becomes more tempting.¹²¹

¹¹⁸ COFFEE & SELIGMAN, *SECURITIES REGULATION*, *supra* note 117, at 6 (citing Artyom Durnev *et al.*, *Law, Share Price Accuracy and Economic Performance: The New Evidence*, PRESENTATION AT THE AMERICAN LAW AND ECONOMICS ASSOCIATION ANNUAL MEETING (May 12, 2001) (examining impact of mandatory forward-looking disclosure in MD&A on share prices)).

¹¹⁹ See Mark S. Croft, *MD&A: The Tightrope of Disclosure*, 45 S.C. L. REV. 477 (1994) (reviewing history of forward-looking disclosure regime and examining litigation arising under it). For a general assessment and prescriptions to reform the forward-looking disclosure regime not using safe-harbors but through formal SEC release articulating its parameters and furnishing detailed guidance, see Joel Seligman, *The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953 (1995); see also Suzanne J. Romajas, Note, *The Duty to Disclose Forward-Looking Information: A Look at the Future of MD&A*, 61 FORDHAM L. REV. 245 (1993) (providing more optimistic assessment).

¹²⁰ In theory, *ex ante* awareness of future punishment for disappointed expectations should constrain managerial optimism; in practice, this constraint is weak. See Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street*, 14 J. APPLIED CORP. FIN. 14 (2002).

¹²¹ Compare Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause other Social Harms)*, 146 U. PA. L. REV. 101, 126 (1997):

Forward-looking disclosure . . . must often be made with less-than-complete confidence of their accuracy, with the nagging sense that with

Not only has inadequate attention been paid to this feature of the contemporary financial reporting environment,¹²² the safe-harbor mechanisms used to address the identified litigation problem appear equally inadequate to their task. Needed is a tool to address both challenges, of constraining undue second-guessing litigation and constraining making forecasts that likely engender pressure to report accounting figures in light of those estimates rather than subsequent business reality.

One possibility exists in SEC rules. The rules governing forward-looking safe harbors invite auditors to provide assurance with respect to forward-looking information contained in the MD&A (as well as other information in the MD&A).¹²³ Issuers have not

more time, doubts about data quality might naturally diminish. From time to time, senior executives will discover, much too late, that the truth is indeed quite different from what they have been led to believe. To be sure, senior executives cannot explicitly acknowledge this. Part of the essential dramaturgical role of senior managers is to communicate confidence and control over their environment, and . . . many management theorists believe that effective corporate disclosure must reflect a comparable level of confidence in control, if not performance, by the senior management group. Thus, even putting aside the possibility that those top managers have their own selfish reasons to distort, there is a substantial risk of a mismatch between what they say and what, once a retrospective look at what all those in the organization actually knew or sensed is undertaken, was "known" by others in the firm.

Mismatch risk poses two challenges: second-guessing litigation, which the securities law framework has addressed, and pressure to finesse a match, to which inadequate attention appears to be paid. *Compare* Mitu Gulati, Jeffrey J. Rachlinski & Donald C. Langevoort, *Fraud by Hindsight*, 98 NW. L. REV. 773 (2004) (examining judicial responses to disappointed expectations arising from prognosis).

¹²² Debate concerning the merits of a forward-looking disclosure system was intense in the 1970s (*see supra* notes 103-114 and accompanying text), but thereafter cooled and the system's role in the financial frauds of the late 1990s and early 2000s was neglected.

¹²³ For example, statutory safe harbors define forward looking statements to mean:

- (A) a statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure, or other financial items;
- (B) a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
- (C) a statement of future economic performance, including any such statement contained in a discussion and analysis of financial

engaged auditors to perform this service, though auditors are eager and willing to provide it. In fact, the AICPA's proposal to render narrative information a formal part of accounting reports indicated that in addition to financial statements, the AICPA would call for the equivalent of the MD&A, including forward-looking information, as a formal part of financial accounting.¹²⁴ Such reliance upon auditors is not likely to be feasible at present given diminished public trust in the auditing profession due to the numerous audit failures of the late 1990s and early 2000s. But it could be attractive when that profession rebuilds public trust, and could help curtail rosy prognostication by naturally-optimistic managers.

Requiring auditors to provide such assurance would not change the inherently unreliability of earnings forecasts, however. A more general alternative to the broad regime of forward-looking disclosure appears. Rather than require, permit, or encourage managers to provide forecasts of earnings, the regime could simply require managers to disclose material risks of future adversity.¹²⁵ The purpose of this regime would be to provide a basis upon which to permit investors to gauge the degree to which a company's numerical history is useful as a guide to probable future performance. Inherently unreliable estimates of future performance would not be required, permitted or encouraged.

B. What's Next?¹²⁶ (Post-Scandal)

condition by the management or in the results of operations included pursuant to the rules and regulations of the commission;

(D) any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B), or (C);

(E) any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or

(F) a statement containing a projection or estimate of such other items as may be specified by rule or regulation of the commission.

Securities Exchange Act, § 21E(a). Item E captures auditor attestations of related disclosure.

¹²⁴ JENKINS COMMITTEE REPORT, *supra* note 91.

¹²⁵ See Donald C. Langevoort, *Managing the Expectations Gap in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1154-56 (2003) (prescribing a complete overall of MD&A to provide "what investors really want and need [which] is a warning of material future risks . . . [and] discussion of their probability and magnitude from management's perspective . . .").

¹²⁶ Pun intended.

If recent cultural pressure on accounting moves it from numerical history to narrative prognosis, both features of the latter trend are reinforced by recent reforms. This shows not only misdiagnose of the disease and questionable prescription, it firmly manifests the depth and ubiquity of modern culture's preoccupation with the future.

1. *Continuous Disclosure System* — The apotheosis of this trend is the pressure for a continuous disclosure system. This is a concept designed to require real-time display of various financial developments.¹²⁷ Long sought by market participants and recently encouraged by the SEC, the Sarbanes-Oxley Act adds force to this movement by directing the SEC to adopt rules to hasten the phenomenon. Under the Act, companies must disclose publicly on a "rapid and current basis" all material changes in their financial condition or operations, including trends, qualitative information and graphic presentations.¹²⁸

The Act uses the word disclose, disguising a more profound shift in market appetite and regulatory philosophy—likewise disguising latent dangers. The innovation of the original federal securities laws was a move to disclosure. Mandatory disclosure, Brandeis famously quipped, is the best disinfectant.¹²⁹ Current pressures for real-time display go beyond disclosure. They move towards transparency.

Contemporary calls for heightened transparency across society often appear as unbounded virtues.¹³⁰ But good reasons appear to doubt this proposition.¹³¹ Bismarck

¹²⁷ See Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985); Dale Arthur Oseterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: Are We There Yet?*, 20 CARDOZO L. REV. 135 (1998); see also Erik D. Prohs, Note, *Periodic Reporting: A Relic of the Past?*, 27 IOWA J. CORP. L. 481 (2002).

¹²⁸ Sarbanes-Oxley Act of 2002, § 501 Pub. L. No. 107-204, 116 Stat. at ____; 15 U.S.C. § 78o-6.

¹²⁹ LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (1914), at 92 ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

¹³⁰ See Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1342 (1996):

Transparency is an eleventh commandment of American life generally, not just of financial markets. We insist on open hearings all through government; we open up to public scrutiny under the Freedom of Information Act the records that elsewhere would be kept confidential; we relentlessly pursue the tax returns and business dealings of almost anyone seeking high public office. We do all this as part of the public's unquestioned (if sometimes exaggerated) "right to know." It comes as no

reportedly cautioned: “If you like laws and sausages, you should never watch either one being made.”¹³² The same is true for those who like financial reports. Consider how managers are to develop this continuous information-display.

Companies generate internal daily financial data, such as sales, accounts receivable balances and charge-offs, and inventory levels and obsolescence. These show trends. They can amount, on a temporary basis, to material changes in financial condition and operation. Mandatory display of these is functionally equivalent to mandatory transparency of business operations on a daily basis. It opens for view daily financial *recording*, not periodic financial *reporting*.

Yet daily changes are not indicative of quarterly or annual aggregates. This information is most useful to managers during an accounting/operating period. It equips them to make course corrections, taking such steps as strengthening sales efforts in lagging segments or improving collection practices when receivables charge-offs rise in certain customer bases. The information is useful to redirect trends and to manage the materiality and direction of financial condition and operation.

Whether corrections succeed take more than a few days of dashboard data to sort out. Premature disclosure of adverse trends may sustain them, disabling managerial redirections. If sales are seen flat in one region, customers in adjacent regions may switch to competitor products; if receivables collections are seen slowing among some customers, other customers may join them. Investors are likely better served giving management time and leeway to make improvements, not respond to them on a daily basis.¹³³

surprise that what is so ubiquitous in our society should affect the financial reporting of the country's major businesses.

Professor Lowenstein's comments addressed the traditional disclosure system, not the kind of transparency digitization injects into discourse. Calls for transparency routinely are heard concerning business, government, international agencies, military operations, diplomatic corps, academia and other organization types. See RUPESH A. SHAH, DAVID F. MURPHY & MALCOLM MCINTOSH, SOMETHING TO BELIEVE IN: CREATING TRUST IN ORGANISATIONS: STORIES OF TRANSPARENCY, ACCOUNTABILITY AND GOVERNANCE (2003); Williams, *Corporate Social Transparency*, *supra* note 97; *see also supra* note 2.

¹³¹ For a careful assessment of the appeal and limits of transparency, using the example of corporate voting in the mutual fund industry, see Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419 (2003).

¹³² Quoted in KERMIT L. HALL, ED., THE OXFORD COMPANION TO AMERICAN LAW (2002), at vii.

¹³³ E.g., Kitch, *Theory and Practice*, *supra* note 65, at 847-861 (general analysis concluding with example of how disclosure concerning Caterpillar Inc. subsidiary in politically-unstable Brazil could have exacerbated political risks); Jonathan R. Macey &

If the new rules under Sarbanes-Oxley only tinker with mandatory continuous display, consider a proposal for pure transparency made by a senior SEC official.¹³⁴ It prescribes changing the existing financial reporting environment using two devices: (1) requiring companies to report real-time bookkeeping information on publicly-accessible Web sites (including real-time journal entries, ledger summaries, monthly aggregations and so on) and (2) requiring management to respond publicly to questions concerning this information.

The theory of this substantive transparency (not mere disclosure) is to equip investors having requisite interest and resources to perform their own financial statement audits of companies, or engage their own auditor to do so. Apart from numerous other practical problems,¹³⁵ it is doubtful that such deep transparency is in the best interests of corporations or investors.¹³⁶ But the proposal shows the enormous new emphasis placed on transparency, not just disclosure.

2. *Auditing's New Early Warning System* — A parallel transparency urge appears in recent auditing reforms. In traditional financial statement audits, auditors speak as of a

Geoffrey Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory*, 42 STAN. L. REV. 1059 (1990) (explaining how managerial withholding of information may benefit investors rather than harm them as often assumed).

¹³⁴ Peter K.M. Chan, *Breaking the Market's Dependence on Independence: An Alternative to the 'Independent' Outside Auditor*, 9 FORDHAM J. CORP. & FIN. L. 347 (2004) [hereinafter, Chan, *Breaking the Market's Dependence*]. When Mr. Chan's article was published, he was Associate Regional Director, Enforcement, in the SEC's Midwest Regional Office. (His views, of course, do not necessarily represent those of the SEC.)

¹³⁵ As examples: (1) supplied information is raw bookkeeping data and limited questionnaire access to management; neither investors nor their auditors have access to a company's system of internal control, audit committees, walk-through exercises, or other essential resources used in traditional auditing and (2) the result would require enormous investor coordination and/or result in numerous separate investor-audits, generating wasteful duplicative costs.

¹³⁶ See Udo C. Brändle & Jürgen Noll, *A Fig Leaf for the Naked Corporation?*, http://papers.ssrn.com/paper.taf?abstract_id=523102 (2004) (making the specific case against utter transparency in corporate financial reporting); see generally Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L. Q. 417 (2003) (expressing more general reservations); Elizabeth J. Boros, *Corporations Online*, 19 COMPANY & SEC. L. ____ (2001) (survey of 100 large Australian companies documents grounds for skepticism as to using corporate Web sites to deliver "universal real-time free access to continuous disclosure information"). This concern is wholly apart from protecting proprietary information that would necessarily be covered by such a proposal. See Chan, *supra* note 134, at 391-92.

moment in time about financial statements prepared as of a prior date and for a prior period, providing hard facts. These are attestations of numerical history. Auditors are financial archeologists. They provide three paragraphs of standardized text to express unqualified opinions, and offer a few additional sentences in other situations.

Reforms implemented in mid-2004 vastly expand the auditor's task, transforming it from financial archeologist of numerical history into a financial forecaster addressed to narrative prognosis. The reform requires auditors to test and opine upon a company's internal control over financial reporting.¹³⁷ The goal is to provide financial statement users with information concerning financial statement reliability.

Though based upon a current examination and providing an opinion about control maintenance during a past accounting period, it is quintessentially about the future—the auditing standard describes itself as creating an “early warning system.”¹³⁸ The early warnings are to be provided using elaborate narrative disclosure provided by the auditor. When no warning is required, the standard form of auditor opinion on control will be akin to the standard three boilerplate paragraphs of the traditional auditor opinion on financial statements; in other situations, the vehicle will go well beyond a few additional sentences.

The key trigger requiring auditor forward-looking narrative disclosure is the existence of a material weakness in such control. The concept of material weakness is forward-looking, defined as risk that material misstatements will not be detected or prevented. The auditing standard requires auditors to describe material weaknesses along with their actual or *potential* future effects on the company's financial statements.

The control audit promotes transparency in the financial reporting process. It may be useful as an antidote to widespread preoccupation with the future seen creating demand and supply for phony financial futures. On the other hand, its likely effectiveness must be evaluated by comparison to the kindred system of forward-looking disclosure in place for business substance since the 1980s. At a minimum, to make this system meaningful likely will require the same kinds of safe harbor concepts developed for the forward-looking disclosure system.¹³⁹ Even those, of course, produced imperfections in the relation between forward narrative and eventual reporting of numerical history. Analogous challenges appear in this control audit innovation.

¹³⁷ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB), AUDITING STANDARD NO. 2: AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS (March 9, 2004) [hereinafter AUDITING STANDARD NO. 2].

¹³⁸ AUDITING STANDARD NO. 2, *supra* note 137, ¶ 6.

¹³⁹ See Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L. J. ____ (forthcoming 2004).

C. Finance Theory's Role

The evolution of accounting from numerical history to narrative prognosis is visibly driven by market demand; less visible is the force of theory. The most powerful theory driving accounting's world in the past thirty years is modern finance theory. Its key concept is the efficient market hypothesis. Under it, all historical information, including accounting data, is rapidly impounded into stock price.¹⁴⁰ Moreover, under this hypothesis, all publicly-available information is accurately interpreted no matter how or where it is presented. These hypotheses—widely believed—imply that any effort to improve accounting theory or practice is meaningless. Finance theory's contribution to accounting is thus its retardation.¹⁴¹

First, efficiency theory says the form of presenting accounting information does not matter. If so, there is no point searching for an ideal form. If identical data can be put in the balance sheet, income statement, cash flow statement, footnotes, or MD&A and generate the same interpretation and result on price, promoting accounting quality is valueless. The disincentives to develop superior accounting are enormous.¹⁴²

Second, efficiency theory says accounting information is instantly useless. Struggles become moot about fidelity in the balance sheet or income statement, about FIFO versus LIFO, about historical cost versus fair value or accrual versus cash. It even would moot—extraordinarily—questions about whether to account for stock options as an expense on the income statement!¹⁴³

¹⁴⁰ See Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (still the leading statement by leading corporate law scholars on market efficiency despite many critiques).

¹⁴¹ Cf. Louis Lowenstein, *Efficient Market Theory: Let the Punishment Fit the Crime*, 51 WASH. & LEE L. REV. 925 (1994).

¹⁴² Cf. Thomas A. Downes & Thomas R. Dyckman, *A Critical Look at the Efficient Market Empirical Research Literature as it Relates to Accounting Information*, 48 ACCT. REV. 300 (1973).

¹⁴³ A leading columnist for the *Wall Street Journal* argues that it doesn't matter whether one accounts for stock options or not, for the market will figure out their significance without regard to accounting. Holman W. Jenkins Jr., *Much Ado About Stock Options*, WALL ST. J., Apr. 3, 2002, at A23:

In the real world [sic], any information, as long as it's deemed relevant, will be processed into the mill for pricing securities. It doesn't matter whether the data is computed into the income statement or appears in a footnote or is shouted up and down Wall Street by a man in a tutu.

Third, efficiency theory says market price responds to cash flow effects of managerial decisions and policy, not to the effect on reported earnings per share. Companies should therefore never seek to manage earnings; investors see through it. If so, accounting need not develop tools to discourage or detect such massage.¹⁴⁴ It won't happen.¹⁴⁵

Efficiency theory is presentation.¹⁴⁶ Presentiate is "[t]o make or render present in place or time; to cause to be perceived or realized as present."¹⁴⁷ In efficiency theory, all numerical history is absorbed into current stock price and becomes instantly irrelevant; all that matters is the future and this too gets "discounted" into price. This model of presentation is theology. Yet its enormous power has retarded accounting as numerical history and reoriented financial reporting to a forward-looking, less reliable, fraud-tempting emphasis on narrative prognosis.

Finance has thus been the foe of accounting, at least as traditional numerical history. Part II's examples of the fair-value movement and cash-flow elevation are products of finance theory's force. On the other hand, despite finance theory's predictions, managers do manipulate accounting forms and markets are fooled.¹⁴⁸ A

¹⁴⁴ See George Mundstock, *The Trouble with FASB*, 28 N.C. J. INT'L L. & COMM. REG. 813, 819 (2003) ("Under efficient market analysis, no regulation of accounting is needed").

¹⁴⁵ E.g., BREALEY & MYERS, *supra* note 73, at 372 ("there are no financial illusions").

¹⁴⁶ The chief contribution of this concept to legal literature was made in respect of criticism of the classical theory of contracts which appeared to hold a conceit that contract formation achieved the reduction of future events to present control. See Ian R. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974). Professor Macneil explained the concept:

Presentation is a way of looking at things in which a person perceives the effect of the future on the present. It is a recognition that the course of the future is so unalterably bound by present conditions that the future has been brought effectively into the present so that it may be dealt with just as if it were in fact the present. Thus, the presentation of a transaction involves restricting its expected future effects to those defined in the present, *i.e.*, at the inception of the transaction.

Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 863 (1978) (footnote omitted).

¹⁴⁷ 8 OXFORD ENGLISH DICTIONARY 1306 (1933).

¹⁴⁸ A dramatic large-scale example is the tele-com industry's capitalizing of line costs that kept their stock prices high; they plummeted when it became clear these should have

burgeoning literature drawing upon behavioral finance undercuts modern finance theory and explains why.¹⁴⁹ A key concept is frame dependence, a bias to apprehend information differently according to how it is presented. The relation to accounting forms is clear. It can matter whether stock options are listed as expenses in the income statement or included in footnote disclosure.¹⁵⁰ Attention to accounting as numerical history remains important and its transformation into narrative prognosis not the inexorable march of progress.

The difficulty with behavioral challenges to efficiency theory is their inherent messiness, contrasted with the elegant beauty of efficient markets. Behavioral theories explain a wide range of often conflicting biases whereas efficiency theory assumes a market behaving as if all actors were purely rational. In fact, however, both accounts of market behavior may be partially correct, producing a middle ground.

Markets may be substantially efficient, but prone to periodic bouts of moodiness better captured by behavioral theories. Such bouts appear to have characterized the late 1990s and early 2000s and their associated financial frauds.¹⁵¹ If so, this experience suggests that accounting forms matter most when they are least likely to be obeyed. Numerical history is thus particularly important during innovative periods such as the late

been expensed. See Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003) (providing description of the largest frauds of the late 1990s and early 2000s, including in the tele-com industry). Another example is how investors responded to different accounting for acquisitions under the now-repealed purchase-pooling distinction. See Patrick E. Hopkins, Richard W. Houston & Michael F. Peters, *Purchase, Pooling and Equity Analysts' Valuation*, ACCOUNTING REVIEW (July 2000).

¹⁴⁹ See Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994) (critique of efficient market hypothesis using chaos theory and noise theory); Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002) (critique of efficient market hypothesis using noise theory and prospect theory).

¹⁵⁰ Numerous other examples appear. Consider America-On-Line's (AOL's) decision whether to capitalize or expense disbursements to build its Internet subscriber data base. AOL capitalized these; the market price reflected this; when AOL changed under pressure to expense these costs, the market price reflected the change. Consider the general practice in the tele-com industry of treating capacity swaps as asset and revenue transactions rather than as liability and expense transactions. See *supra* note 148.

¹⁵¹ See ROBERT SHILLER, *IRRATIONAL EXUBERANCE* (2002); see also ANDREI SCHLEIFER, *INEFFICIENT MARKETS* (2001).

1990s and early 2000s when market appetites for narrative prognosis peak. In this middle ground, reliable accounting is a central piston in the efficient market engine.¹⁵²

CONCLUSION

Accounting is best when conceived as numerical history, though even this conception faces limits. So conceived, a mix of rules and principles constituting generally accepted accounting practice furnishes a fair presentation of historical financial performance resulting in a current financial circumstance. Attempting to move the numerical system to provide information of a forward-looking character is formidable. Narrative is essential. Narration can be even more limited, however, when used as prognostication. Forward-looking information is inherently more likely to disappoint than historical data. In the best of worlds, the latter is what it is, while the former is what people's expectations and hopes determine it to mean.

The digitized-information age demands from accounting what it cannot reliably deliver. Debates focusing on rules versus principles or GAAP versus fair presentations miss these points. Reforms directed towards enhancing the orientation toward the future not only miss the points but exacerbate what they miss. Accounting must walk before it can run. Inherent limits suggest at most capacity for a rapid crawl. The horse is out of the gate, however, not to be yoked; the challenge is to look forward in accounting reform as much as market demand looks forward in its appetite for information obscured in cloudy crystal balls. One solution is to curtail the scope of forward-looking disclosure, replacing earnings forecasts with warnings of material risks of adverse developments.

This Article does not end on a false dichotomy but appreciates the need for accounting as both numerical history and narrative prognosis.¹⁵³ It warns, however, that the optimal mix likely weighs more heavily on its qualities as numerical history than narrative prognosis. One lesson from late 1990s/early 2000's accounting frauds is the balance tipped the wrong way. Feeding the beast of digitized and information-hungry culture must be accompanied with training it.¹⁵⁴ Mankind has long dreamt of knowing

¹⁵² See Calvin Johnson, *Accounting in Favor of Investors*, 19 CARDOZO L. REV. 637 (1997).

¹⁵³ See *supra* note 84 (noting role of prognosis in traditional accounting as numerical history).

¹⁵⁴ It is ironic that digitization poses such challenges for accounting understood as numerical history. After all, digitization is the process of transforming information (including narrative and graphic displays) into codes expressed in numbers (0 and 1) to facilitate computer processing and electronic transfer. Words-into-numbers sounds like accounting; for accounting, however, digitization resulted in numbers-into-words. Compare Bernhard Grossfeld, *Global Valuation: Geography and Semiotics*, 55 SMU L. REV. 197, 224 (2002) (meditation on ascendancy of numbers over letters amid digitization).

tomorrow's news today and digitized culture whets that appetite because it seems so much more within reach. In accounting and securities regulation, however, hunger for tomorrow's news today can be perilous.¹⁵⁵ Caveat culture.

¹⁵⁵ Cf. *Chiarella v. United States*, 445 U.S. 222 (1980) (insider trading conviction arising from *Wall Street Journal* columnist privately and criminally sharing tomorrow's news today).

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